

Impact of OECD BEPS Action 7 proposals on modification of Articles 5(4), 5(5) and 5(6) of OECD Model Convention

An evaluation of Action 7 on the future of intra-group transactions and business models of MNEs in their cross-border investments

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The notion of permanent establishment (PE) is one of the most important issues in treaty-based international fiscal law; it is perhaps the single most important and dynamic one, too.

With openness in economies, globalisation and rapid development of e-commerce business models, there is a complete change in the way business is carried out throughout the world by multinational companies (MNE). Traditional ways of doing business have given way to modern and rather flexible ways of operating globally. Naturally, taxing rules need to keep up the pace at which businesses are evolving. It is extremely crucial that taxes are paid at the place where substantial activity and operations of multinationals effectively take place. To achieve this, the Organisation of Economic Co-Operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Project identifies Action 7 to prevent the issues of artificial avoidance of PE status. This Action seeks to revamp the definition and scope of PE as is currently existing in Article 5 of the OECD Model Convention on Income and on Capital.

Whilst examining the recommendations of BEPS Action 7, the authors will analyse how the existing rules of Article 5(4) (dealing with preparatory and auxiliary activities), Article 5(5) (dealing with Agency PE rule) and Article 5(6) (dealing with exclusion for Independent Agents) are likely to be modified. The authors will also evaluate how these changes are likely to have an impact on Singapore's existing treaties (if these changes are re-negotiated in existing treaties, whether bilaterally or through the BEPS Multilateral Instrument (MLI)). The paper will also shed light on how these changes could impact business models and supply chains in a post-BEPS world.

It must be noted that BEPS Action 7 recommendations are proposed to give effect to the PE Article in existing treaties by way of the MLI, under development by the OECD as per BEPS Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties).

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Content

1.	Background and Introduction	4
1.1	Significance of the concept of Permanent Establishment (PE) in international tax law.....	4
1.2	Evolution of the concept of PE.....	4
1.3	How were companies organising themselves before BEPS and why was this considered egregious?	6
1.4	Wake of BEPS	7
1.5	How BEPS Action 7 propose to modify the current rules of permanent establishments under Article 5 of OECD MC - A snapshot	8
1.6	Scope of the paper and exclusions	10
2.	Modification of Article 5(4): Exception from PE for preparatory or auxiliary activities (PoA activities)	11
2.1	Article 5(4) of the OECD MC: Pre-BEPS scenario	11
2.2	Current controversy: Ambiguity on automatic application	11
2.2.1	View 1: Activities listed under subparagraphs (a) to (d) of Art 5(4) automatically qualify for PE exemption and need not be additionally tested for PoA criteria.....	12
2.2.2	View 2: Activities under (a) to (d) are not automatic exemptions and need to satisfy the criteria of being preparatory or auxiliary in nature	13
2.2.3	Concluding thoughts	16
2.3	Putting an end to the controversy: Action 7 proposals on Art. 5(4).....	16
2.3.1	Illustrations emanating from the Action 7 Report	17
2.4	Impact on Singapore's tax treaties	19
2.5	Impact on treaties with "research activities" exception	19
2.6	Impact on business models / supply chains.....	20
2.7	Case study: Distribution of goods through limited-risk distributor ("LRD"), storage of goods at own warehouse (OECD-patterned treaty).....	22
3.	Proposal for a new Art. 5(4.1) - The anti-fragmentation rule.....	24
3.1	What is the anti-fragmentation rule? What is the problem that this rule seeks to tackle?.....	24
3.2	Impact of the anti-fragmentation rule on Singapore treaties.....	26
3.3	Impact on business models and supply chains.....	27
3.4	Case study: Distribution of goods through LRD, storage of goods at A Co's own warehouse	27
4.	Modification of Article 5(5) of the OECD MC (Agency PE).....	29
4.1	What are Commissionaire arrangements? How are they relevant for Singapore?	29
4.1.1	Relevance of "substance over form" approach in Singapore (common law jurisdiction)	29
4.1.2	Conclusion	31
4.2	What are the Action 7 proposals with regard to Agency PE?.....	31
4.2.1	Comparison between current and proposed Article 5(5).....	32
4.2.2	Principles emanating from the revised scope of Agency PE under Art. 5(5):	33
4.2.3	Principles emanating from the revised commentary on Art. 5(5):	33
4.2.3.1	'Acting on behalf of'	33
4.2.3.2	'Concludes contracts'	34
4.2.3.3	'Such activities need to be done habitually'	35
4.2.3.4	'Principal role leading to conclusion of contracts without material modification'	35
4.2.3.5	'In the name of'	35
4.2.4	Exclusions from Extended Agency PE (EAPE) rule	35
4.3	Action 7 proposals introduce the EAPE Rule covering agent's activities directly resulting in contract conclusion. How would the EAPE Rule impact arrangements where sales and marketing activities are undertaken in Singapore and the contract is fulfilled by the FE outside Singapore?	35
4.3.1	Discussion concerning sales and marketing activities	36
4.3.2	Impact of EAPE Rule on sales or marketing function - Analysis	38
4.4	What are Action 7 proposals in relation with Agency PE for contracts with "standard terms"? How is Agency PE exposure in terms of standard contracts presently evaluated?	39

4.4.1	Current treatment of “standard contracts”	39
4.4.2	BEPS Action 7 Proposals in relation to “standard contracts”	41
4.4.3	Conclusion - is the current scenario rather favourable?	41
4.5	What would be the impact of Action 7 proposals relating to Agency PE [Article 5(5)] under the existing Singapore treaties?	42
4.5.1	OECD-patterned treaties:	42
4.5.2	Treaties with stock maintenance and delivery agents	43
4.5.3	Treaties with ‘securing orders’ rule in Agency PE	44
4.5.4	Manufacturing or processing agents	47
4.6	Impact on business models and supply chains	48
4.7	Case studies	50
4.7.1	Sales and marketing activities carried out in another state with support from a local subsidiary	50
4.7.2	Case study 2: Digital operating models - Sale of software products via own website to customers in another state (with support services performed by a local subsidiary)	52
5.	Modification of Art. 5(6) (Independent Agents)	54
5.1	What are the BEPS Action 7 proposals regarding Independent Agents under Article 5(6) of the current OECD Model Convention?	54
5.1.1	Comparing the amendments	54
5.1.2	Meaning of ‘ordinary course of business’	55
5.1.3	Meaning of ‘exclusively or almost exclusively’	55
5.1.4	Concept of “Closely Related Enterprises” (CREs)	56
5.1.5	Interplay between Art 5(7) and Art 5(6) in case of parent subsidiary relationship	58
5.2	What would be the impact of Action 7 proposals relating to Independent Agents [Article 5(6)] under the existing Singapore treaties?	58
5.2.1	OECD-patterned treaties	58
5.2.2	Agents exclusive to principal	59
5.2.3	Agents exclusive to principal and related enterprises	60
5.2.4	Arm’s length principle (ALP) condition for Agency PE	60
5.2.5	Summary of impact	60
6.	Can ambulatory approach be adopted to use the proposed commentary for interpreting the existing Singapore treaties?	62
6.1	Proposed Changes to Article 5	62
6.2	When can ambulatory approach be applied?	62
6.3	How can ambulatory approach be applied to rely on Action 7 proposals in relation to changes in OECD commentary, to interpret existing treaty?	63
7.	How will BEPS Action 7 proposals be implemented?	64
7.1	Multilateral Implementation:	64
7.2	Bilateral Implementation:	64
8.	What is Singapore’s role in the OECD BEPS project?	65
9.	Concluding thoughts	66

1. Background and Introduction

1.1 Significance of the concept of Permanent Establishment (PE) in international tax law

The notion of PE is one of the most important issues in treaty-based international fiscal law. It is perhaps the single most important and dynamic one, too. This statement is confirmed by the fact that virtually all of present-day tax treaties use PE as the main instrument to establish taxing jurisdiction over a foreigner's unincorporated business activities. In general, PE refers to a "fixed place of business" through which a company conducts some or all of its operations. As stated in the commentary to Article (Art.) 7(1) of the OECD Model Convention on Income and on Capital (MC), a foreign enterprise's profits from business activities are taxable in the country where the activities are performed only if the enterprise has a PE in that country. For the same purpose, the concept of PE is decisive also in the international fiscal laws of many countries, including the Income Tax Act (ITA) of Singapore, which defines and uses the term PE for certain "deeming" tax rules. Thus, the concept of PE is crucial since it is the decisive criteria as to when a company's activities in a foreign country create sufficient nexus, so as to subject its business profits to income tax in the source country.

The existence of a PE gives rise to several tax effects. The most important and obvious effect, both from legal and practical viewpoints, is that the PE principle under tax treaties is decisive in determining a non-resident enterprise's tax obligation due to "unincorporated" business activities with economic allegiance to more than one country (i.e., through a branch office, representative office, project office etc.). However, there are several implications that determine the existence of PE or otherwise; for example, PE determination overrides taxation of passive incomes like dividends (Art. 10), interest (Art. 11), royalties (Art. 12) as "business income" if these are effectively connected with PE. The treatment of personal taxation (Art. 15) also varies if there is existence of a PE in the country in which employment is exercised. Special provisions in tax treaties also exist to protect against tax discrimination if the enterprise has a PE in that state. Furthermore, domestic laws often refer to PE or a fixed place of business even when PE is not used to decide taxing jurisdiction in that country's domestic laws. Finally, any changes in the PE standard can have significant implications in terms of compliance and administration costs, potential uncertainty and controversy and risk of double taxation.

1.2 Evolution of the concept of PE

The history of the PE clause in tax treaties dates back to as far as the history of tax treaty itself. The starting point was when enterprises from Central European countries expanded their activities to neighbouring countries in the middle and end of the 19th century and were held liable to tax both in their state of residence and under the domestic laws of the Source State, either because they carried on a "trade or business" or maintained a PE there. This saw the evolution of important model conventions such as the drafts of the League of Nations from 1927, 1933 and 1943 (the Mexico model treaty), the OECD MC from 1963, the revision of this model in 1977 and finally the United Nations (UN) MC from 1980. However, the wording of the draft conventions has changed gradually in the course of the 60 to 70 years since the onset of this process. The newest versions of the OECD and UN models today have been recently updated in 2014 and 2011 respectively.

The current structure of Art. 5 (PE) of the OECD MC, which has remained unchanged for many years now, reads as follows:

Article 5(1): The general definition of PE in the OECD Model treaty, which reads as *“For the purpose 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”* (fixed place PE).

Article 5(2): An illustrative list of places such as a branch, office, factory etc., which are expressly included in the definition of PE.

Article 5(3): Constitution of PE by virtue of a building site or construction or installation project if it lasts more than twelve months (construction PE or installation PE).

Article 5(4): Exceptions from PE for activities of a preparatory or auxiliary (PoA) character.

Article 5(5): Dependent agents constituting a PE of the principal (Agency PE).

Article 5(6): Exclusion from Agency PE for independent agents.

Article 5(7): Clarification that a subsidiary controlled by a foreign parent does not necessarily constitute a PE of the foreign parent.

The constant reminder of the lack of a clear and precise meaning of PE has led to scholars and professionals requesting for clarity in the PE concept in order to eliminate uncertainty and ambiguity, so that taxpayers are well informed prior to expanding their operations. It has always remained debatable with regards to whether the dynamic nature of the concept of PE has managed to keep abreast with the ever-evolving nature of how MNEs conduct business globally. As businesses evolve, the PE concept has been put to the test before Courts and analysed by academics and authors. This leads to the need for updating the principles. Perhaps there can never be a clear answer to the PE riddle in the context of today’s international tax system. Regardless, the OECD and the UN have invested a lot of time and effort in refining the concept of PE in the recent past. A roadmap of the evolution of the PE concept by the OECD in the recent pre-BEPS times is set out below. This is in addition to the regular updates to Art. 5 of the OECD MC from time to time.

Dates	Particulars
April 2004	Report titled <u>“Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?”</u> by the OECD (2004 TAG report)
December 2006, April and August 2007, July 2008 and July 2010	<u>Reports on the attribution of profits to PEs by the OECD</u>
12 October 2011	Discussion draft on the <u>“Interpretation and Application of Article 5 (PE) of the OECD MC”</u> by OECD (followed by public comments and consultation meeting)
19 October 2012	<u>Revised proposals concerning the interpretation and application of Article 5 (PE) by the OECD</u> (followed by public consultation)

1.3 How were companies organising themselves before BEPS and why was this considered egregious?

Existence of a PE attracts taxation for a foreign company in the source country, to the extent that profits of the foreign company are attributable to the PE. Whilst some MNEs factor PE rules into their structuring so as to avoid double taxation, others go one step further. In such cases, certain MNEs have attempted to arrange their structure, arrangements and contractual agreements such that they do not create a “taxable presence” in any country in which they operate. Whether to avoid double taxation or to create “double non-taxation”, management of PE has thus been one of the most important objectives for MNEs evaluating structures and operating models.

Profits derived by companies are subject to tax in the Source State only where a sufficient “taxable nexus” between the economic activities and the Source State is established. In other words, a certain amount and degree of business activity must take place in that country. Over time, however, some companies have designed arrangements to limit or circumvent PE status, leaving profits untaxed in the country where the economic activities took place. This could have been achieved, illustratively, by the following means:

- ▶ Operating through a fixed place of business for display, storage or delivery activities and seeking exemption under Art. 5(4) for PoA activities, carefully managing the extent of activities even if the activities would naturally and in a reasonable commercial context would have exceeded such PoA or auxiliary nature.
- ▶ Fragmentation of a cohesive operating business into smaller operations in order to argue that each is merely engaged in PoA or auxiliary activity.
- ▶ Splitting up of construction contracts into several parts so that each part does not exceed the period threshold required to constitute a PE.
- ▶ Use of commissionaire and similar arrangements (i.e., an arrangement through which a company sells products in a given country in its own name but on behalf of a foreign enterprise that is the owner of such products).
- ▶ Exploiting the extant liberal threshold to contest that agents are “independent agents” and hence do not constitute a “Dependent Agency PE”.

In addition, the initial development of the PE concept did not anticipate the rise of the “stateless” digital economy. It has become possible to do business through the internet without creating substantial physical presence today.

These developments have led to tax leakages for governments. Whether intentional or not, companies, have long irked revenue authorities and tax administrations globally. It has always been a concern that a non-resident is able to derive substantial profits from a source market without creating a taxable presence, thus being seen to shift profits out of the country. Relevant provisions and guidance were not adequately provided for in the OECD MC and the commentary thereto, from which many tax administrations take their cues.

This was acknowledged by the OECD in its report titled “*Addressing Base Erosion and Profit Shifting*” (February 2013) (BEPS Report). The BEPS Report identifies the root causes of BEPS and notes that tax planning leading to BEPS turns on a combination of coordinated strategies. The following paragraph from the above BEPS Report relates to the current treaty definition of PE:

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

1.4 Wake of BEPS

The OECD took over the task of refining the PE rule as part of its BEPS project, which began in early 2013. The BEPS Report recognises that the current definition of PE had to be changed in order to address strategies employed by companies to avoid paying tax. The action plan on BEPS (OECD BEPS Action Plan) identified and noted the above concern as:

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

[...]

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

Thus, the OECD formulated an “Action” to address this concern as follows:

Action 7 - Prevent the Artificial Avoidance of PE Status

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

On 5 October 2015, the OECD released its final report on Action 7, i.e., “Preventing the Artificial Avoidance of Permanent Establishment Status” (Action 7 Report) under its OECD BEPS Action Plan. The Action 7 Report aims to update the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS and make it more adapt to the modern business world. Action 7 proposals are understood to have expanded the definition of PE. Once implemented, these Action 7 proposals will have a wide impact on the taxation of business profits of MNEs in foreign countries.

Action 7 proposals are also intended to deal with challenges of the digital economy as discussed in Action 1, “Addressing the tax challenges of the digital economy¹”. Further, Action 7 has been classified as a “reinforced international standard”, which means that the existing concept of PE will undergo a required update under the BEPS Plan.

The roadmap of evolution of PE rule under Action 7 of the BEPS project has been as follows:

Dates	Events
February 2013	<u>OECD Report “Addressing Base Erosion and Profit Shifting” (BEPS Report)</u>
July 2013	<u>OECD “Action Plan on Base Erosion and Profit Shifting” (BEPS Action Plan)</u>
October 2014	<u>First Discussion Draft (DD) on preventing artificial avoidance of PE under BEPS Action 7</u>
January 2015	<u>Comments on first DD submitted to OECD with public consultation</u>
March 2015	<u>OECD Working Party (WP) 1 reviewed the options included in first DD</u>
May 2015	<u>Revised DD released</u>
June 2015	<u>Comments received on revised DD submitted to OECD and discussed by OECD WP to finalise the outcome of Action 7</u>
October 2015	Final Report on Action 7 released
July 2016	Discussion draft on attribution of profits to PEs
End of 2016	Multilateral Instrument implementing treaty-based BEPS recommendations under Action 7 is expected to be open for signature

1.5 How BEPS Action 7 propose to modify the current rules of permanent establishments under Article 5 of OECD MC - A snapshot

Area of focus	Proposed changes to OECD MC (and commentary)
Article 5(3) : Construction PE	<ul style="list-style-type: none"> ▶ Application of general anti-abuse rule: Introduction of an example in commentary of Art. 5(3) on applying the principal purpose test (PPT) rule to clarify non-applicability of treaty benefit in case of abusive transaction. ▶ Automatic Rule of aggregation to be included in commentaries as an alternative provision to be used in treaties to aggregate the time spent by Closely Related Enterprises (CRE) on connected activities at same site when determining PE threshold.

¹ Action 1 of the OECD BEPS project deals with the tax challenges arising on account of digital economy. It notes that because the digital economy is increasingly becoming the economy itself, it would not be feasible to ring-fence the digital economy from the rest of the economy for tax purposes. The report notes, however, that certain business models and key features of the digital economy may exacerbate BEPS risks and shows the expected impact of measures developed across the BEPS Project on these risks. The report also describes rules and implementation mechanisms to enable efficient collection of value-added tax (VAT) in the country of the consumer in cross-border business-to-consumer transactions, which will help level the playing field between foreign and domestic suppliers. The report also discusses and analyses options to deal with the broader tax challenges raised by the digital economy, noting the need for monitoring developments in the digital economy over time.

Area of focus	Proposed changes to OECD MC (and commentary)
	<ul style="list-style-type: none"> ▶ Provision of illustrative list of guiding factors to determine whether activities are “connected”.
Article 5(4) on preparatory or auxiliary exemption	<ul style="list-style-type: none"> ▶ Narrowed scope of PE exemption to listed activities under Art. 5(4). ▶ Blanket condition for listed activity to qualify as PoA in nature. ▶ New anti-fragmentation rule.
New Article 5(4.1) on an anti-fragmentation rule	<ul style="list-style-type: none"> ▶ New anti-fragmentation rule denying Art. 5(4) exemption on fulfilment of following conditions. <ul style="list-style-type: none"> ▶ Where the foreign enterprise (FE) or a CRE has a PE in Source State or where the overall combined activities of FE and the CREs exceed PoA threshold. ▶ The business activities of FE and CRE constitute complementary functions forming part of cohesive business operations. ▶ Proposed commentary on application of above provision.
Changes to Article 5(5) on Agency PE	<ul style="list-style-type: none"> ▶ Expand the scope of Agency PE under Art. 5(5). ▶ Pre-requisite of a formal authority with agent to conclude contracts omitted. ▶ Introduction of Extended Agency PE (EAPE rule) to cover cases where agents habitually play principal role leading to routine conclusion of contracts without material modification by the FE (i.e., to target commissionaire arrangements). ▶ EAPE rule also to apply for contracts that are for transfer of properties owned by the FE or for provision of services by FE, even if not in the name of FE. ▶ Changes to commentary to explain application of the EAPE rule with phrases like “acting on behalf of”, “authority to conclude contract”.
Changes to Article 5(6) on independent agents	<ul style="list-style-type: none"> ▶ Independent agent criteria made stricter with inclusion of a criteria that agent may not be independent if he works “exclusively or almost exclusively” for the principal or CREs. ▶ Activities performed for CREs required to be considered whilst determining exclusivity. ▶ CRE defined based on common control, 50% beneficial interest. ▶ Commentary explains application of “exclusive or almost exclusive” criteria. ▶ 90% threshold illustrated to determine “exclusively or almost exclusively” criteria.

1.6 Scope of the paper and exclusions

The aim of this paper serves to articulate the various proposals of OECD BEPS Action 7, which seeks to redefine the concept of PEs under Art. 5 of the OECD MC and how these changes may impact transactions and business models of MNEs. The above changes, to the extent pertaining to changes to Arts. 5(4), 5(5) and 5(6) and their impact analysis are discussed in depth hereunder in this paper. For ease of practical understanding, case studies have been illustrated to depict the impact of changes, wherever required.

This paper, however, does not deal with issues relating to (i) changes to Art. 5(3) on artificial splitting of contracts, (ii) issues that may crop up in terms of tax impact, reporting obligations and compliance once a PE is found to be existing in the Source State and (iii) issues relating to profit attribution for PEs and work by the OECD under the BEPS project relating to profit attribution.

It must be noted that Action 7 recommendations are proposed to be given effect to the PE Article in existing treaties by way of the Multilateral Instrument (MLI) being under development by the OECD as per BEPS Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties).

This paper has been written at a time where the MLI is neither available for endorsement nor are the details, draft and scope of the MLI known. The impact analysis has been prepared on the basis that Singapore will be a signatory to the MLI. Also, the manner of application of MLI to existing treaties and flexibilities, which may be granted to signatory countries is not known.

2. Modification of Article 5(4): Exception from PE for preparatory or auxiliary activities (PoA activities)

2.1 Article 5(4) of the OECD MC: Pre-BEPS scenario

Art. 5(4) of the OECD MC provides a list of activities, which if carried on through a fixed place of business, do not constitute a PE. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. The decisive criterion whether an activity is PoA or not lies in *whether or not the activity forms an essential and significant part of the enterprise as a whole*². A fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise does not constitute a PoA activity.

The OECD MC includes the following activities in Art. 5(4):

- 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.*

These activities (listed activities), if carried on through a fixed place of business, do not constitute a PE of the foreign enterprise in the Source State. These activities are thus considered as exceptions to PE.

2.2 Current controversy: Ambiguity on automatic application

As the context of Art. 5(4) and its appended commentary would show, the listed activities do not constitute a PE because of the presumed insignificance of the nature of these activities and their contribution to profits of the business overall. The commentary to OECD MC on Art. 5 at paragraph 21 states that, a common feature of these activities is that they are, in general, PoA activities and it is in the case of clause (e) that this is explicitly laid down, which amounts to a general restriction of the scope of definition in paragraph 5(1). However, looking at the Model Article, only paragraphs (e) and (f) refer to PoA activities³.

² OECD MC (2014) Commentary on Art. 5(4) paragraph 24

³ Commentary by Philip Baker on Art. 5(4) at paragraph 5B.20

This has raised a significant question and debate: when activities carried on fall under clauses (a) to (d) of Art. 5(4), is this place of business automatically exempted from PE or do the activities need to fulfil the condition of being of a PoA character for the enterprise, so as to be exempted from PE status?

There are two possible views on this controversy.

2.2.1 View 1: Activities listed under subparagraphs (a) to (d) of Art 5(4) automatically qualify for PE exemption and need not be additionally tested for PoA criteria

The following arguments support that the items listed under (a) to (d) are always exempt from PE under Art. 5(4) and are not required to be further tested as being PoA in nature.

- ▶ The text of Art. 5(4) is clear to attach the PoA test only to subparagraphs (e) and (f). This is also acknowledged by Prof. Philip Baker in his commentary⁴ where he suggests that the PoA test is relevant only for subparagraphs (e) and (f).

“... it is only paragraphs (e) and (f), which refer to preparatory or auxiliary activities. Art. 5(4)(a) to (d) mention specific activities; 5(4)(e) includes any other activities of a preparatory or auxiliary character and 5(4)(f) includes a combination of activities so long as the overall activity is of a preparatory or auxiliary character. On the wording of the Model Article itself, it is only in connection with other activities, not specifically mentioned [paragraph (e)] and with a combination of activities [paragraph (f)] that it is necessary to decide if the activities are preparatory or auxiliary.”

Under this argument, in view of the clear language of the provisions of Art. 5(4), the benefit of PE exemption should be automatically available to activities listed under Art. 5(4)(a) to (d).

- ▶ The OECD Report on “Issues arising under Article 5 of the Model Tax Convention” (2002) made strong observations supporting this view. These observations were made whilst evaluating whether storage facilities would qualify for exemption. Relevant extracts are as follows:

“These activities [(a) to (d)], unlike other activities described in subparagraph (e), are always exempt and are not subject to examination for whether or not they are truly preparatory or auxiliary. These conclusive presumptions were initially adopted to provide certainty to taxpayers that their income from these activities would be taxable, if at all, only in the country of residence.”

- ▶ The issue has been discussed time and again within the OECD and it is featured as part of various reports. The discussions therein indicate that present OECD MC and commentary do not suggest that activities under subparagraphs (a) to (d) are specifically subject to a PoA condition for granting the exemption. These reports suggest amending the OECD MC to clarify this issue.
- ▶ The Working Group (WG) of Discussion Draft on the Interpretation and Application of Article 5 in October 2011 and October 2012 raised a question as to whether the activities that are mentioned in subparagraphs 4(a) to (d) are automatic exceptions or if these exceptions are conditional on the activities being of a PoA nature. The group agreed that application of these exceptions was not subject to the additional condition that the relevant activity must be of a PoA character, which was a condition that was expressly included in sub-paragraphs (e) and (f). It was decided to clarify in the commentary that the exception applies automatically where one of the activities listed in Art. 5(4) is the only activity carried on at the fixed place of business.

⁴ Double Taxation Conventions (3rd Edition) by Philip Baker, QC on Art. 5, paragraph 4

- ▶ The above view, however, did not meet the consensus of all delegates. Some argued that the proposed interpretation does not conform to the original purpose of the paragraph, i.e., to only cover exception for PoA activities. The WG thus invited a working party to examine “whether the conclusion that the listed activities under clauses (a) to (d) of Art. 5(4) are not subject to the extra condition that the activities should be of a PoA character is appropriate in policy terms” as against the automatic application of the exception.
- ▶ Following this, the 2012-13 “Revised discussion draft on Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention” specifically covers the issue at Q.12 “Must the activities referred to in paragraph 4 be of a preparatory or auxiliary nature?”. It noted the observations of the 2004 OECD TAG Report. Further, the working party of the revised discussion draft agreed that the wording of sub-paragraphs (a) to (d) **did not** support the view that the application of these sub-paragraphs was subject to the additional condition that the relevant activity be of a PoA character, which was a condition that was expressly included in sub-paragraphs (e) and (f). It therefore agreed that the commentary should be amended **to clarify** that sub-paragraphs (a) to (d) should apply automatically and it is not subject to the extra condition of the activities to be of a PoA nature.
- ▶ Some international jurisprudence has seen Courts applying PE exemption under Article 5(4) automatically without subjecting the same to further subjective tests. Refer illustratively to cases⁵ of the Belgian Court in this regard.
- ▶ The above discussions in OECD reports suggest that the intent of Art. 5(4) is to cover activities, which are only PoA in nature. However, the present language does not make the activities under subparagraphs (a) to (d) subject to PoA condition and hence, recommendations are made to make the change clarifying the above. However, until such clarification is made, it is arguable that the activities under subparagraphs (a) to (d) may not be treated as subject to PoA condition.

2.2.2 View 2: Activities under (a) to (d) are not automatic exemptions and need to satisfy the criteria of being preparatory or auxiliary in nature

The following arguments support that the intention of the Article is to exempt all activities of a PoA nature. Hence, items under clauses (a) to (d) need to be of PoA nature to qualify for exemption.

- ▶ Paragraph 21 of the commentary to OECD MC states paragraph 5(4) is designed to prevent an enterprise of one state from being taxed in the other state, if it carries on in the other state, activities of a purely PoA character. Hence, the intention is to exempt only the activities that are PoA in nature. Further, Klaus Vogel⁶ acknowledges that the list refers to activities only of a PoA character. Refer to extracts as follow:

“21. This paragraph lists a number of business activities, which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities... Thus the provisions of paragraph 4 are designed to prevent an enterprise of one state from being taxed in the other state, if it carries on in that other state, activities of a purely preparatory or auxiliary character.

⁵ IBFD Case No. 2005/AR/477 of 16 January 2007 (Belgium Court); Richold SA v. Belgian State (dated 30 November 2014)

⁶ Klaus Vogel on Double Tax Conventions (3rd edition, M. No. 108. Page 318)

...The facilities and activities enumerated in the list of exceptions to the permanent establishment concept do not constitute permanent establishment even if they satisfy all the requirements laid down in Art. 5(1). The list refers to activities of a preparatory or auxiliary character, such activities being exempted from permanent establishment taxation."

- ▶ The rationale as explained by OECD commentary for exclusion of these activities from purview of PE is that a place of business carrying on such activities may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. This feature is common to all activities under (a) to (e) and not only to clause (e).
- ▶ Clause (e) reads as *"maintenance of fixed place.... for **any other activity** of a preparatory or auxiliary nature"*. The term "any **other** activity" suggests that this clause (e) provides an open end to a list, which otherwise consists of activities of a PoA nature. Here, "other" qualifies the term *"activities of a preparatory or auxiliary nature"*, which may be read as any preparatory or auxiliary activity "in addition to" the above list.
- ▶ Also note the following extract from the commentary of Klaus Vogel⁷, which suggests that Art. 5(4) is one comprehensive carve-out of PoA activities and activities in subparagraphs (a) to (d) are examples of such a carve-out:

*"The internal structure of Article 5(4) OECD and UN MC requires some thoughtful unbundling. It is obvious that sub-paragraphs (a) to (d) describe four different though similar alternatives, whereas sub-paragraphs (e) and (f) reflect a broader and more abstract concept. It is particularly these last-mentioned sub-paragraphs, which suggests a synthetic rather than an analytical interpretation of the preceding sub-paragraphs (a) to (d). **The difference in wording between these first sub-paragraphs can be regarded as exemplifications of a homogeneous concept of subordinate place of businesses, as described in Article 5(4)(e) and confirmed and amalgamated in Article 5(4)(f) of OECD and UN MC.***

This synthetic approach is supported by the view expressed by the OECD MC Comm. that the common feature of all activities listed in Article 5(4) OECD and UN MC is that they are, in general, preparatory or auxiliary activities (no. 21 OECD MC Comm. on Article 5). It is particularly Article 5(4)(e) OECD and UN MC that ties the single elements in sub-paragraphs (a) to (d) together. In other words, Article 5(4)(a) to (d) OECD and UN MC do not constitute specific carve-outs of Article 5(1) OECD and UN MC, but are designate examples of one comprehensive carve-out."

- ▶ OECD's 2004 TAG Report of the Business Profits TAG discusses that the activities listed under sub-paragraphs (a) to (d) are intended to be of PoA character only and a change in MC or commentary to subject such activities to PoA test would only be a clarification. Refer to the following extracts:

"The option to subject the activities covered by the exception to the overall limitation that they be of a preparatory or auxiliary nature is based on the same rationale but is arguably better targeted as it implicitly restricts the exceptions to activities that contribute only marginally to the profits of the enterprise. It could also be argued that this alternative option is fully in line with the purpose of paragraph 21 of the

⁷ Klaus Vogel on Double Taxation Conventions, 4th <for consistency; if not spell out "Third" for previous footnotes of such based on what is printed as per the book> Edition, page 376

commentary:

“The common feature of these activities is that they are, in general, preparatory or auxiliary activities [...] —Thus the provisions of paragraph 4 are designed to prevent an enterprise of one state from being taxed in the other state, if it carries on in that other state, activities of a purely preparatory or auxiliary character.

...The alternative option to make all the exceptions subject to the preparatory or auxiliary condition would reduce certainty by subjecting the existing exceptions that currently apply automatically and therefore provide a bright line test to a condition that is inherently more subjective. The change would therefore increase the potential for disputes between taxpayers and tax authorities. In light of paragraph 21 of the Commentary on Article 5, it could be argued, however, that there is already some uncertainty as to whether or not all the existing exceptions are implicitly subject to this condition.”

- ▶ An important criteria for PoA activities is that such activities are not essential or significant to the general purpose of the entity’s business. This criteria may be relevant for the activities listed under Art. 5(4)(a) to (d) as well. To illustrate: if a foreign enterprise, whose primary purpose is collection of information, performs such activities in the Source State, Art.5(4)(d) exemption is inapplicable because collection of information is no longer “PoA” in nature for the foreign enterprise. This proposition is indicative in the following references:
 - ▶ As per Arvid Skaar⁸, collection of information for an enterprise’s headquarters through an office abroad is considered an auxiliary activity, unless the collecting of information is the primary purpose of the enterprise. A similar view is expressed by the Indian Authority for Advance Rulings (AAR) in the case of K.T. Corporation⁹.
 - ▶ Her Majesty’s Revenue and Customs (HMRC) Manual (INTM266120) illustrates an example in stating that collection of market research information is not PoA for a foreign enterprise whose main trade is concerned with market research.
 - ▶ In a recent decision of the Japanese Court¹⁰, a taxpayer had a warehouse located in Japan for storage and delivery and for the receipt of returned products. In analysing the existence of a PE, the court held that to qualify for PE exclusion under Art. 5(4) of the US - Japan Treaty (which is equivalent to Art. 5(4) of the OECD Model Convention) activities need to be PoA in character. The court noted in particular that a warehouse located in Japan for quick delivery to customers and the ability to handle returned products were important elements of the online retail business. Because these activities and other activities performed in Japan were in fact “significant” for an online retail business, the court upheld the existence of a PE in Japan.
 - ▶ The Spanish Administrative Court¹¹ and the Russian District Court¹² also applied the condition of PoA nature to decide whether PE exemption under Art. 5(4) may be available or not.

⁸ Permanent Establishment - Erosion of a Tax Treaty Principle by Arvid Skaar (1991)

⁹ In re (181 Taxman 94)

¹⁰ Source: EY Global Alert on “Japanese court decision impacts taxation of online business warehouses” dated 25 November 2015

¹¹ IBFD Case No. 0657/2003 (Spanish Administrative Court) dated 2 March 2006

¹² Russian ruling - IBFD Case No. A40-94391/10-142-134)

- ▶ Thus, as per this view, activities, whether listed or not, need to be of a PoA nature to be entitled for PE exemption.

2.2.3 Concluding thoughts

As a result of the above ambiguity in application of Art. 5(4), specific activity exemptions were open to abuse. Activities performed in a Source State, for example delivery of goods, purchasing of goods or collecting information, which in fact were core functions for some businesses (depending on the facts and circumstances), adding significant value to the taxpayer's business were exempted from PE automatically by virtue of Art. 5(4). Profits were instead taxed in the state where the taxpayer was resident, often subject to a comparatively low corporate tax rate. Such models could not even be checked through Transfer Pricing (TP) attribution principles since in the absence of the constitution of PE, no profit could be attributed to the Source State on the lines of Art. 7. Hence, this came to be one of the more publicised examples of BEPS.

2.3 Putting an end to the controversy: Action 7 proposals on Art. 5(4)

As detailed above, both the views regarding whether the PoA test should be applied are plausible and arguments exist in support of each of the propositions. In 2013, the OECD took over this issue as part of the BEPS Action Plan. As per the report on Action 7, the OECD felt that regardless of the original purpose of the exceptions included in sub-paragraphs (a) to (d) of Art. 5(4), it is important to address situations where these give rise to BEPS concerns.

Action 7 puts the above controversy to rest by proposing to modify the scope of Art. 5(4) by introducing a "blanket qualification" that the activities under Art. 5(4)(a) to (d) must be of a PoA character to be eligible for PE exemption. The existing Art. 5(4) of the commentary may accordingly be amended as below:

"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 or 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 sub-paragraphs (a) to (e). ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character~~*

provided that such activity or, in the case of sub-paragraph (f), the overall activity of the fixed place of business is of a preparatory or auxiliary character."

The proposed change in Art. 5(4), if implemented, is likely to make the claim of PE exemption stricter. All the listed activities, which were hitherto eligible for exemption automatically (in general) will now be subject to qualification as PoA in nature. As stated in the proposal to the

revised commentary, “the final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character”. In other words, an enterprise carrying on the listed activities cannot automatically claim PE exemption without qualifying the “PoA” test in substance.

Since the test will now be mandatory but nonetheless remains subjective, the Action 7 Report provides additional guidance in the proposed commentary to clarify the meaning of the terms “preparatory” and “auxiliary” (*paragraph 21.2 of the proposed commentary on Article 5*). This is summarised as follows:

“Preparatory”

- ▶ As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole.
- ▶ Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise.
- ▶ This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else.
- ▶ Example: training provided by a construction enterprise to its employees at one place before sending them to the remote construction site is preparatory activity for the construction enterprise.

“Auxiliary”

- ▶ On the other hand, an activity that has an auxiliary character generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.
- ▶ It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

2.3.1 Illustrations emanating from the Action 7 Report

The report also proposes to introduce several illustrations in the commentary to the OECD.

Commentary to provide further guidance on the meaning of the terms “preparatory and auxiliary”.

Article 5(4)(a): the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise.

- ▶ Examples of activities eligible for exception, not constituting a PE:
 - ▶ Bonded warehouse, used by exporter of fruits from another state, solely for storing fruits in controlled environment during custom clearance process.
 - ▶ Delivery: fixed place of business maintained solely for delivery of spare parts to customers for machinery supplied to them - without an obligation of servicing.
 - ▶ Facilities such as cables or pipelines owned by a FE, used to transport its own property crossing territories of various countries where such transportation is merely incidental to the business of the enterprise (e.g., oil refinery).
- ▶ Examples of activities not eligible for exception, constituting a PE:

- ▶ Enterprise maintains in another state a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in that other state.
- ▶ Maintenance of a fixed place of business for the delivery of spare parts to customers for machinery supplied and, in addition, for the maintenance or repairs of such machinery.
- ▶ Where "delivery" function constitutes core function or is supplemented by core activity.

Article 5(4)(b): the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.

- ▶ Examples of activities not eligible for exception, constituting a PE:
 - ▶ Where the foreign enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, sub-paragraph (b) is applicable and the question of whether a PE exists will depend on whether these activities constitute a PoA activity.

Article 5(4)(c): the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise.

- ▶ Examples of activities eligible for exception, not constituting a PE:
 - ▶ Stock of goods of foreign enterprise maintained by a toll-manufacturer for the purpose of further processing:
 - ▶ No PE if place of toller is not at disposal of FE.
 - ▶ If FE has (unlimited) access to a separate part of the facilities of the toll-manufacturer for inspection and maintenance of stock stored therein, eligibility to claim exemption would depend on whether such activities are PoA in nature.

Article 5(4)(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.

- ▶ Examples of activities eligible for exception, not constituting a PE:
 - ▶ Enterprise operates a number of large discount stores, maintains an office in another state during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow the enterprise to establish stores in that state. During that period, employees of the enterprise occasionally purchase supplies for their office.
 - ▶ Occasional purchasing activity by office in Source State where the overall activity profile of the office has PoA character.
 - ▶ Insurance enterprise collecting information such as statistics on risks etc.
 - ▶ A newspaper bureau collecting information on possible news stories without advertising.
 - ▶ An investment fund collecting information on possible investment opportunities in Source State.
- ▶ Examples of activities not eligible for exception, constituting a PE:
 - ▶ Purchasing office where the employees who work at that office are experienced and well paid buyers who visit producers in that state, determine the type or quality of the products

according to international standards and enter into different types of contracts (spot or forward) for the acquisition of the products by enterprises.

- ▶ Where purchase represents core function:
 - ▶ Where overall activity of FE is selling goods purchased.
 - ▶ FE has a purchase office in Source State and it procures large amount of agricultural products produced in Source State and sells to FE distributors in different countries.
 - ▶ Supply of information along with furnishing of plans etc. specially developed for customer.

Article 5(4)(e): Activities not expressly listed in (a) to (d) as long as that activity has preparatory or auxiliary character.

- ▶ Examples of activities eligible for exception, not constituting a PE:
 - ▶ Advertising or supply of information, if such activities are of a PoA nature.
 - ▶ Conclusion of contracts by employee (agent) of a foreign enterprise for carrying out exempted activities [covered under Art 5(4)] will not constitute an Agency PE under Art. 5(5). For example, if the manager of a fixed place of business carrying on PoA activities concludes contracts necessary for hiring and maintaining that place, there is no agency PE.
- ▶ Examples of activities not eligible for exception, constituting a PE:
 - ▶ A research establishment that concerns itself with manufacture.
 - ▶ Where servicing of patents and know-how is the purpose of the enterprise.
 - ▶ Managing an enterprise or a part thereof or part of a group of the concerns from Source State, for managerial activity exceeds the PoA level. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity with a PoA character.

This is how BEPS Action 7 proposes to modify Art. 5(4) of the OECD MC and the commentary.

2.4 Impact on Singapore's tax treaties

As per Action 7 proposals on Art. 5(4), all activities listed under Art. 5(4)(a) to (d) are required to meet the PoA criteria to qualify for the exemption. Hence, all of Singapore's tax treaties based on the OECD Model (illustratively Finland, South Africa, and Spain) will be subject to the stricter condition; activities will need to qualify the PoA condition to be eligible for PE exemption, as discussed in the above paragraphs.

Of course, any impact (as discussed above) on Singapore's existing tax treaties will take place only if they are re-negotiated bilaterally with the respective countries or if Singapore becomes a signatory to the MLI, which reflects the new wordings of Action 7 recommendations. In other words, there is no automatic impact or change in the existing treaties if Singapore does not sign the MLI or re-negotiate its existing bilateral treaties.

2.5 Impact on treaties with "research activities" exception

Under some treaties [e.g., Art.5 (4)(e) of Singapore - France treaty], "scientific research" is specifically included in the list of activities that are exempt from creating a PE. Under such treaties, a possible view is that research activity is automatically exempt from creating a PE and there is no requirement for such expressly included activity to additionally fulfil the PoA criteria.

The OECD commentary (at paragraph 23) gives an example whereby "research activity" is exempt from creating a PE. In addition, based on certain commentaries, there is a suggestion that research

for self is generally considered “auxiliary” in nature. However, this should not be considered as a general rule. Practically, if the research function is of significant importance to the core business of the enterprise (e.g., in case of technology companies, life sciences or pharmaceutical companies) and research function can be directly related to actual realisation of profits, one may adopt a conservative approach even under the existing treaties such that the important research activity is not treated as automatically exempt. This approach will also be in line with the intent of PE exemptions under Art. 5(4), i.e., to exempt activities that are PoA in nature.

Assuming the version of Art. 5(4) in the MLI completely overrides Art. 5(4) under existing treaties, the result would be that PE exclusion for “research activities” will be deleted from such treaties since the Action 7 version of Art. 5(4) does not contain a specific mention for scientific research. However, the mention continues in the OECD MC in Action 7. Thus, even in the post-BEPS era, research activity may be exempt from creating a PE if the same qualifies as PoA in nature based on the overall factors of the arrangement.

Assuming that such treaties continue to contain the exception for “research activities”, the Action 7 proposal may amount to codification of the approach already being adopted (i.e., testing the research function to be auxiliary in nature) to claim the exemption.

2.6 Impact on business models / supply chains

The changes proposed under Action 7 are fundamental for multinational companies that operate both centralised and de-centralised models. Whatever the business reasons for centralisation decisions of companies (e.g., lower costs, efficiency), centralised operating models create cross-border business activities between related parties of multinational groups.

The changes to Art. 5(4) will potentially impact any company that:

- ▶ Owns inventory stored in other countries.
- ▶ Has group entities operating as toll manufacturers.
- ▶ Has centralised certain group functions (e.g., procurement)¹³.

With respect to facilities owned by a FE (e.g., principal) in a centralised business model for the purposes of storage, delivery or purchase of inventory, it will be necessary for companies to analyse whether relevant activities performed in the other country constitute an essential and significant part of the FE’s business. In this respect, it is important to note that relevant commentaries address that it is unlikely that an activity that requires a significant portion of the assets or employees of the enterprise could be considered as having an auxiliary character.

Another common inventory-holding scenario that may now present multinationals with potential PE risk involves the use of consignment inventory arrangements where ownership of consigned inventory placed at the premises of the customer remains with the FE. In such situations, the FE may need to re-evaluate its options for its end-to-end supply chain management. This may mean keeping the existing consignment inventory structure and acknowledging that a PE may be created (bearing in mind that this may actually be a prerequisite to doing business in the other country for certain industries) or move toward a local inventory ownership structure, which typically has the drawback of making supply chain management more cumbersome and potentially inefficient.

Likewise, the same logic applies to situations involving foreign-owned (e.g., principal) inventory held at a toll manufacturer for processing. This means that the policies and procedures in place regarding warehouse or toll manufacturer access and stock control will need to be evaluated to see

¹³ Implications with respect to other functions such as sales and marketing are described in section 4.3 of this document.

if these need to be modified to ensure that no PE is created.

In cases where an FE utilises premises owned and operated by another (local) company that are not at its disposal, there is no further need to evaluate whether the inventory holding activity performed at this place is of PoA character as this will not lead to a PE of the FE (i.e., no fixed place PE). Action 7 provides an example where an independent logistics company operates a warehouse in State A and continuously stores in that warehouse goods or merchandise belonging to an enterprise based in State B. In that example, the warehouse does not constitute a fixed place of business at the disposal of the foreign enterprise. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein; the question of whether a PE exists will depend on whether these activities constitute a PoA activity.

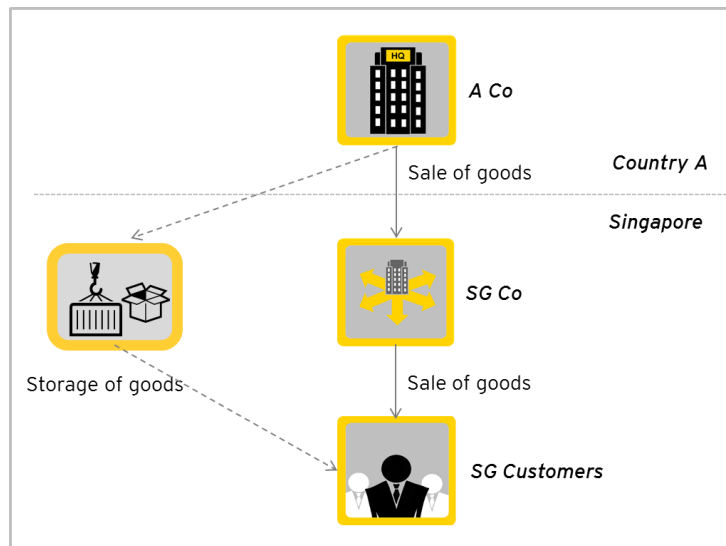
With respect to centralisation of functions, it will become more challenging for multinationals to find the right balance between PE risk management versus efficient operating model. To the extent that tax costs outweigh commercial benefits, there may be a need to re-evaluate the necessity of centralising certain key processes and functions, to perform a review of the roles and responsibilities relating to the management of those key processes and performance of those functions, as well as check where these roles are being performed. In certain situations, there may be a need to move functions in order to mitigate PE. Improvements to the oversight, data collection and documentation of where people are, what they are doing and who they are doing it for will be key to assessing whether the existing operating model is robust enough to withstand PE risk challenges and whether there are opportunities for improvement.

In terms of ITA of Singapore, the definition of "PE" was introduced under the Amendment Act in 1977 and is now included in the interpretation section, Section 2. As the term is not referred to in the charging section (Section 10), the mere fact that an entity falls within the definition of the term does not *ipso facto* mean that the entity will be deemed to have income "accruing in or derived from Singapore".

The Inland Revenue Department (IRD) (the agency preceding IRAS as then known) in a press statement in 1977 had stated that, "*whether or not profits will be attributable to a permanent establishment including representative office would depend on the nature of the activities it carries out*". The IRD had confirmed, inter alia, that the following types of activities would not come within the ambit of Section 10, even if it falls within the definition of PE in Section 2. Though "PoA" was not expressly mentioned in the press statement, the intent of the clarification appears to be along similar lines as PoA exemption from PE:

- 1) A mere purchasing function in Singapore of a foreign entity.
- 2) Stocks of goods warehoused in Singapore for delivery but no trading activities are carried on in Singapore.

2.7 Case study: Distribution of goods through limited-risk distributor (“LRD”), storage of goods at own warehouse (OECD-patterned treaty)



Facts and business model:

- ▶ A Co is a company based in Country A engaged in the trading of goods (i.e., machinery and spare parts) in different countries.
- ▶ SG Co is a wholly-owned subsidiary of A Co and acts as LRD exclusively for A Co's goods in Singapore.
- ▶ SG Co sells goods to Singapore customers on its own account and not on behalf of A Co.
- ▶ Goods are sold by A Co to SG Co as and when SG Co enters into a contract with a Singapore customer to sell the same (i.e., flash title).
- ▶ SG Co's premises are not at the disposal of A Co.
- ▶ A Co's personnel do not visit SG Co's premises.
- ▶ To facilitate quick delivery, A Co has taken a warehouse on lease in Singapore wherein the goods sold to SG Co are stored and delivered therefrom. A Co has its employees at the warehouse who strictly undertake storage and delivery function and do not carry out any other business activities (e.g., maintenance and repairs of the machinery sold by A Co) and do not have an authority to conclude contracts on behalf of A Co.
- ▶ When SG Co enters into contracts with its customers in Singapore, the goods owned by A Co are sold to SG Co prior to the sale to the customer and delivered from the warehouse directly to the Singapore customers as per instruction of SG Co.

What is the impact of the Action 7 proposals on PE aspects of A Co in Singapore?

- i. **Current scenario (under OECD-patterned treaty):**
 - ▶ PE exposure on account of LRD in Singapore: No fixed PE and/or Agency PE exposure.
 - ▶ PE exposure on account of A Co's warehouse in Singapore: Warehouse leased and operated by A Co in Singapore will qualify as fixed place PE if it satisfies the conditions under Art. 5(1) of OECD MC (i.e., place of business test, permanence test, business

activity test and disposal test). However, Art. 5(4) of the OECD MC excludes storage and delivery function from the scope of the PE definition; hence, no fixed place PE.

ii. **PE exposure based on Action 7 proposals:**

- ▶ PE exposure on account of LRD in Singapore:
 - ▶ No fixed PE, no change from the current position.
 - ▶ Agency PE: Since SG Co, being LRD, acts on its own account, it is unlikely to trigger Agency PE under the proposed Art. 5(5) (regardless of how long the LRD would hold title to the goods).
- ▶ PE exposure on account of A Co's warehouse in Singapore:
 - ▶ Storage and delivery need to qualify as PoA in order to result in PE exemption. The PoA character of storage and delivery will need to be determined in the light of factors that include the overall business activity.
 - ▶ In the commentary to the proposed Art. 5, it is stated as an example that the storage and delivery of goods to customers is regarded as PoA in nature, hence activities undertaken in A Co's warehouse in Singapore should qualify for the PoA exemption resulting in A Co not having a PE in Singapore.
 - ▶ This would not be the case if A Co would maintain a warehouse in which a significant number of employees would work for the main purpose of storing and delivering goods to customers in Singapore (e.g., online sales). Delivery functions being directly linked to the sales activity are unlikely to be regarded as PoA in nature (i.e., PoA exemption under Art. 5(4) would be denied).

3. Proposal for a new Art. 5(4.1) - The anti-fragmentation rule

3.1 What is the anti-fragmentation rule? What is the problem that this rule seeks to tackle?

To qualify for PE exemption under Art. 5(4), the enterprise must carry on activities only of a PoA nature through a fixed place of business in the Source State. If the FE performs multiple activities in the Source State, it is likely that the cumulative level of activities will exceed the PoA threshold and lead to PE exposure in the Source State for the FE.

To get around this difficulty, companies could easily establish different places of business in the Source State and allot different activities to different places that each place of business performs only PoA activity, though the sum total reckoned together may exceed such level. The result would be that no individual place of business forms PE of the FE in the Source State. To tackle this, the current paragraph 27.1 of the commentary to OECD MC on Art. 5 deals with what is referred to as "fragmentation of activities". This paragraph reads as:

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

However, this paragraph only tackles the abuse of a single FE operating several places of businesses in the source country. As per the Action 7 Report, some countries consider that BEPS concerns related to Art. 5(4) essentially arise where there is fragmentation of activities between closely related parties and that these concerns will be appropriately addressed by the inclusion of an anti-fragmentation rule as Art. 5(4.1). The Action 7 Report thus recognises that, given the ease with which subsidiaries may be established, the logic of the last sentence ("*[a]n enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity*") should not be restricted to cases where the same enterprise maintains different places of business in a country but should be extended to cases where these places of business belong to closely related enterprises (CRE).

To the extent that the anti-fragmentation rule is introduced, some countries may feel that BEPS concerns are addressed and hence there is no need to modify Art. 5(4), i.e., the list of exceptions in subparagraphs (a) to (d) of paragraph 4 should not be subject to the condition that the activities referred to in these subparagraphs be of a PoA character (as discussed above). The report thus gives an option to countries to retain the current version of Art. 5(4), i.e., not subject the activities to a blanket condition provided they introduce the recommended anti-fragmentation rule. It is the choice given to every member country as to which of the two options they wish to adopt.

Some BEPS concerns related to Art. 5(4) will therefore be addressed by the rule proposed below, which will take account not only of the activities carried on by the same enterprise at different places but also of the activities carried on by CREs at different places or at the same place. This new rule is the logical consequence of the decision to restrict the scope of Art. 5(4) to activities that have a "preparatory and auxiliary" character because in the absence of that rule, it would be relatively easy to use CREs in order to segregate activities which, when seen together, go beyond

that threshold.

The new anti-fragmentation rule proposed in Art. 5(4.1) reads as follows:

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

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

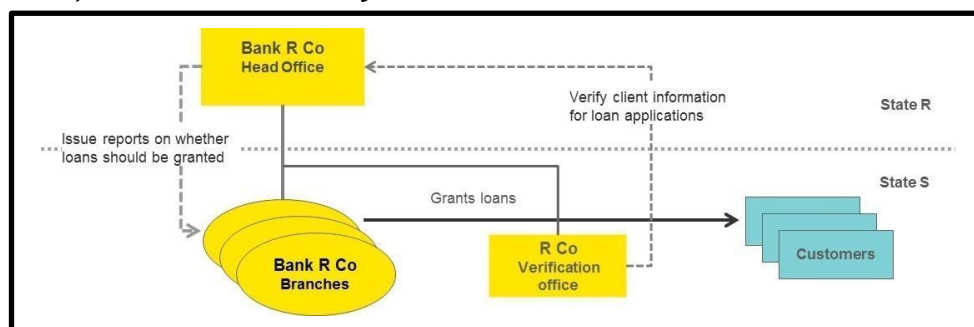
b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.”

Thus, the purpose of paragraph 4.1 is to prevent an enterprise or a group of CREs from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a PoA activity.

For paragraph 4.1 to apply, at least one of the places where these activities are exercised must constitute a PE or, if that is not the case, the overall activity resulting from the combination of complementary activities must go beyond what is merely PoA.

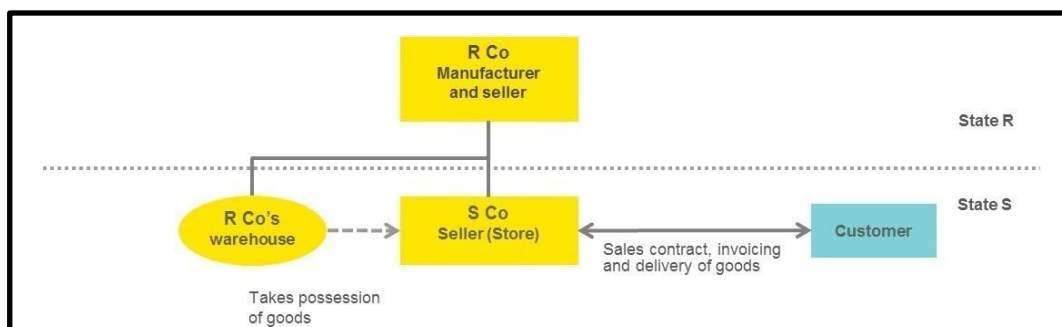
Illustration of operation of the anti-fragmentation rule - 1



Facts: R Co, a bank resident of State R, has a number of branches in State S, which constitute PEs. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of R Co in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made.

Conclusion: Exceptions of paragraph 4 will not apply to the office because another place (i.e., any of the other branches where the loan applications are made) constitutes a PE of R Co in State S and the business activities carried on by R Co at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e., providing loans to clients in State S).

Illustration of operation of the anti-fragmentation rule - 2



Facts: R Co, a company resident of State R, manufactures and sells appliances. S Co, a resident of State S that is a wholly-owned subsidiary (WOS) of R Co, owns a store where it sells appliances that it acquires from R Co. R Co also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by S Co. When a customer buys such a large item from S Co, S Co employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by S Co from R Co when the item leaves the warehouse.

Conclusion: In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph 4 (a), applies to the warehouse.

The conditions for the application of paragraph 4.1 are met because:

- ▶ S Co and R Co are closely related enterprises.
- ▶ The business activities carried on by R Co at its warehouse and by S Co at its store constitute complementary functions that are part of a cohesive business operation (i.e., the storing of goods in one place and the selling of these goods through another place).

3.2 Impact of the anti-fragmentation rule on Singapore treaties

It may be noted that some tax treaties (e.g., Singapore - India tax treaty) have a somewhat comparable clause, which provides that Art. 5(4) exemption will not be available if the FE maintains any other fixed place of business in the Source State. However, no tax treaty deals with fragmentation of activity with a CRE or Associated enterprise (AE) of the above kind.

The existing anti-fragmentation rule in the OECD commentary covered only activities undertaken by the enterprise itself. However, under the proposed rule, enterprises with activities carried out by a group of CREs at the same or different locations may now create a PE risk, if (i) they are performing “complementary business activities as part of a cohesive business operation” and (ii) such activities when combined, exceed what is PoA.

Of course, any impact (as discussed above) on Singapore’s existing tax treaties will take place only if they are renegotiated bilaterally with the respective countries or if Singapore becomes a signatory to the MLI, which reflects the new wordings of Action 7 recommendations. In other words, there is no automatic impact or change in the existing treaties if Singapore does not sign the MLI or re-negotiate its existing bilateral treaties.

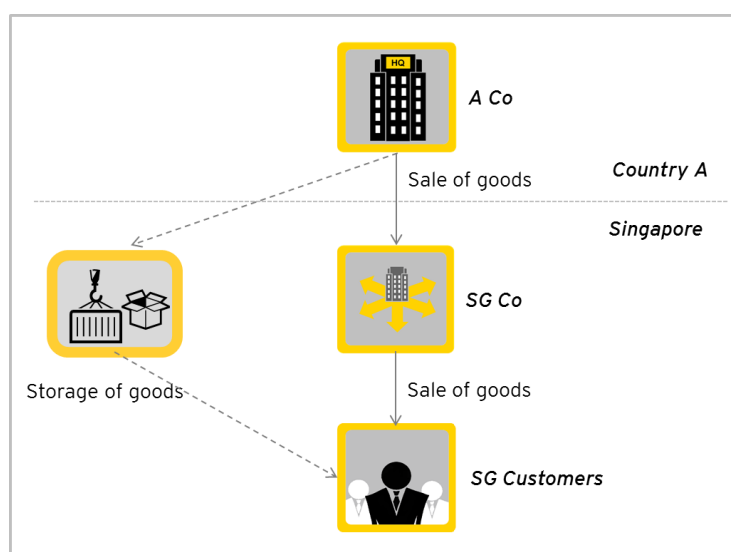
3.3 Impact on business models and supply chains

It may be noted that application of the new rule goes beyond cases of artificial fragmentation. Hence, it may impact genuine business arrangements involving CREs. For example, in cases where departmentalisation of activities among entities within a group is done based on their expertise or specialisation or to cater to the ever increasing quality standards in the global market, it may have commercial justifications but nevertheless get impacted by the new rules, increasing PE exposure.

Hence, with the introduction of the anti-fragmentation rule, it will be more important than ever for multinational companies to be able to substantiate the business reasons for allocating various functions and risks along their value chains over different group entities within the same jurisdiction. This may not be so as to reduce the PE exposure - a PE may nonetheless be created under the proposed rules. But the key point behind this is the quantum of profit attribution on account of such multiple presence in the source country. This is more important in times where many multinationals have moved to functional specialisation and matrix structures where there is a deliberate separation of functions (e.g., sales and manufacturing) or where a specific manufacturing site in one country focuses on producing similar products for multiple jurisdictions. Another typical example would be the establishment of central warehouses, which go hand-in-hand with central inventory management, ownership and overall Sales and Operations Planning. These would appear to be logical reasons for the perceived legal and managerial fragmentation of key activities along the value chain.

In addition to the above, many taxpayers may find themselves faced with a multitude of PEs and additional compliance costs. For example, there is a risk that the recognition of a PE for corporate tax purposes may trigger immediate wage tax and social security obligations, regulatory and license commitments hence companies need to be alert on managing that risk.

3.4 Case study: Distribution of goods through LRD, storage of goods at A Co's own warehouse



As outlined in section 3.1, the OECD member countries will be given the choice whether to modify Art. 5(4), i.e., PoA related modifications, or introduce the proposed anti-fragmentation rule. Alternatively to the analysis outlined in the case study under section 2.7, if Singapore would implement the above anti-fragmentation rule, activities carried out at the warehouse and functions performed by SG Co would be considered together for the purposes of the PE analysis.

The commentary to the proposed anti-fragmentation rule provides an example wherein, in a similar fact pattern, it is concluded that the functions performed at the warehouse and those performed at SG Co's premises are complementary functions forming part of a cohesive business operation.

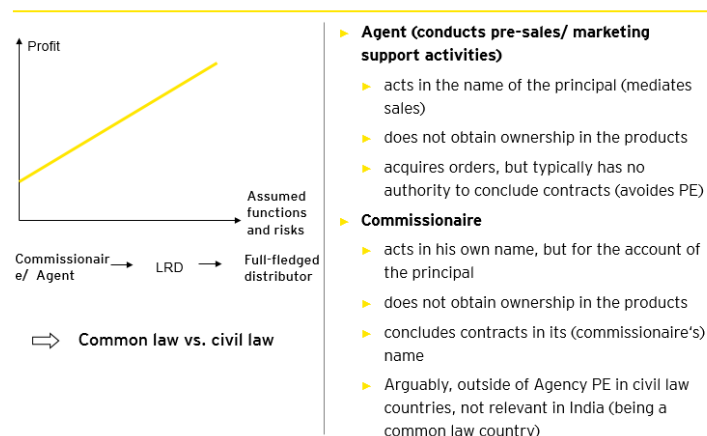
Accordingly, in this case, the anti-fragmentation rule would be triggered and the exclusion under Art. 5(4)(a) would not be available to A Co, i.e., a PE of A Co would be created in Singapore on account of the warehouse as well as LRD (i.e., SG Co in this example).

4. Modification of Article 5(5) of the OECD MC (Agency PE)

4.1 What are Commissionaire arrangements? How are they relevant for Singapore?

In the general context, a commissionaire arrangement (a civil law concept) refers to an arrangement whereby a person sells products in its own name but on behalf of another enterprise (being the owner of these products). Presently, such commissionaire arrangements are found in some countries across the EU. Such arrangements have been judicially accepted to remain outside the purview of Agency PE due to the impact of the civil law read with specific language in the tax treaty, which refers to conclusion of contracts “in the name of” the enterprise. Under a commissionaire arrangement, contracts are concluded in the name of the agent (commissionaire), whilst the obligation to perform is in the name of the owner of the goods who sells directly to the customer. Therefore where the contracts between the commissionaire and the customer do not legally bind the principal, no PE for the principal can be found.

Sales structure profiles



Commissionaire is a civil law concept and is also recognised under European Civil law concept of agency. Singapore is a common law country and under common law, commissionaire arrangements are not of significant relevance. Under common law concepts, even if a contract is signed by an agent on its own account, the undisclosed principal is legally bound to the third party by virtue of the contract made by an agent acting within its authority. Hence, agency PE is created where the contract binds the FE towards the third party even if such contract is signed by the agent in its own name, whether or not the name of the FE is disclosed in the contract. Under common law system, actual conduct is considered more relevant in determination of Agency PE.

4.1.1 Relevance of “substance over form” approach in Singapore (common law jurisdiction)

The following commentaries indicate the significance of substance over form approach in common law countries:

- ▶ The UK HMRC Manual - INTM266160, in this regard, states that it is necessary to see the presence of the non- resident principal in the actions of the resident agent¹⁴.

"In the UK, under common law, we interpret any actions carried out by an agent as having been performed for the principal and binding the principal in the same way as though they had carried out those actions themselves. For example, a contract arranged by an agent in the UK to deliver goods owned by a foreign principal to a customer would be treated for UK tax purposes as though the foreign principal themselves had contracted in the UK for the delivery. This is the case, regardless of whether the contract is written in the name of the principal or in the name of the agent (commentary to model treaty Article 5(5), paragraph 32.1 of July 2010 version)."

- ▶ OECD commentary on Art. 5(5)

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

- ▶ Commentary by Prof. Klaus Vogel (3rd edition - paragraph 140, page 331)

*"The question whether such a person has an **authority to conclude contracts** within the meaning of treaty law must be decided not only with reference to private law but must also take into consideration the **actual behaviour** of the contracting parties. An approach relying solely on aspects of private law (the law of contracts) would make it easily possible to prevent an agent from being deemed a permanent establishment (and therefore, to prevent the enterprise from being taxed by the state in question) even where he is engaged most intensively in the enterprise's business: he would be allowed only to negotiate contracts up to the point when they were finalised and ready to be signed, but the final signature, to satisfy the properties, would be reserved to someone from the enterprise's headquarters in the other contracting state. **Such a formal split-up of business responsibilities on the one hand and legal authority on the other hand, is considered by Strobl & Kellmann to constitute a case of "tax circumvention"** (see supra Art. 1, m. nos. 78ff.) **where substance should prevail over form; a permanent establishment, should therefore, be deemed to exist irrespective of what the formal arrangement were** [Strobl, J., & Kellmann, C. 15 AWD 405, 408(1969)]. It is submitted that the solution is even simpler, since the agent in question had **in fact** an authority to conclude contracts, even if not under private law (the law of contract), but at all events within the meaning underlying Art. 5. In other words, decisive for Article 5(5) is the substance of the authorization, not its form (Avery Jones, J.F., & Ward, D.A., supra m.no.1, at 353, 162). Corresponding clarification is already to be found in some DTCs (cf., e.g., Germany's DTC with Malaysia, paragraph 3(b) Prot. Art 5)."*

- ▶ Commentary by Klaus Vogel (4th edition - paragraph 331, page 387)

*"As a rule, it is sufficient that the **principal accepts and acknowledges the results** of the actions taken and contracts negotiated by the agent. Considering a high degree of arbitrariness if merely formal act of finally signing a contract were decisive, we propose a substance-over-form*

¹⁴ Source : <http://www.hmrc.gov.uk/manuals/intmanual/INTM266160.htm>

approach with regard to the authority to conclude contracts test: if it belongs to the typical activities of the agent to communicate with the third party and to discuss and arrange (spontaneously or after the agent has sought the consent of the principal) the main features of the contract, it is immaterial if the final signature is made by the agent on behalf of the principal, or by the principal himself. It is required, however, that the principal will follow the arrangements of the agent in the overwhelming majority of cases. According, to this yardstick, a recent decision of the Dutch Court of Appeal of The Hague deserves full approval."

- ▶ Commentary by Prof. Philip Baker (paragraph 5B.266, page 5-2/13)

"There was significant change to the Commentary at paragraph 32 in 1994 by the addition of a sentence to the effect that the agent need not enter into contracts literally in the name of the principal, so long as the agent concludes contracts which are binding on the enterprise. Thus the common law agent for an undisclosed principal - who binds the principal to a contract - would be embraced. It follows that an "agent" who represents a foreign enterprise but does not conclude contracts binding on the principal never falls within Article 5(5): an estate agent, for example, may represent the vendor of a property but has no authority to conclude contracts binding on the vendor. Thus, a travelling sales man employed in Canada by a Unites States enterprise but with no power to conclude contracts did not constitute permanent establishment. The authority to conclude must be habitually exercised: an occasional exercise would not give rise to a dependent agent permanent establishment.

4.1.2 Conclusion

Singapore is a common law country and under common law, commissionaire arrangements are not of significant relevance. Under common law concepts, even if a contract is signed by an agent on its own account, the undisclosed principal is legally bound to the third party by virtue of the contract made by an agent acting within its authority. Thus, even if contracts are not concluded in the name of principal, the agency PE rule will likely be triggered under existing Singapore treaties.

Also, international jurisprudence (especially a long list of jurisprudence in India¹⁵ - another common law country) unanimously seems to have followed the "substance over form" approach whilst dealing with the issue of conclusion of contracts by an agent for the foreign principal. A purposive interpretation of Art. 5(5) would mean that Agency PE may trigger even if the contract is concluded in the name of agent but performance of which is on account of foreign enterprise.

Thus, BEPS Action 7 proposals on Art. 5(5) may not have a significant impact on this front in common law countries such as Singapore, since commissionaire arrangements may constitute PE in such countries even today.

4.2 What are the Action 7 proposals with regard to Agency PE?

The Action 7 proposals concerning Agency PE are mainly devised to tackle the PE avoidance caused due to commissionaire arrangements. BEPS concerns arising from commissionaire arrangements may be illustrated by the following example, which is based on a court decision that dealt with such an arrangement and found that the foreign enterprise did not have a permanent establishment.

- ▶ X Co is a company resident of State X. It specialises in the sale of medical products.
- ▶ Until 2000, these products are sold to clinics and hospitals in State Y by Y Co, a company resident of State Y. X Co and Y Co are members of the same multinational group.

¹⁵ Refer illustratively, Indian JV. Co., In re [2005] 143 TAXMAN 71 (AAR), Morgan Stanley, In Re [2006] 152 TAXMAN 1 (AAR), Motorola Inc [2005] 95 ITD 269 (DELHI)(SB).

- ▶ In 2000, the status of Y Co is changed to that of commissionaire following the conclusion of a commissionaire contract between the two companies. Pursuant to the contract, Y Co transfers to X Co its fixed assets, its stock and its customer base and agrees to sell in State Y the products of X Co in its own name, but for the account of and at the risk of X Co.
- ▶ As a consequence, the taxable profits of Y Co in State Y are substantially reduced.

It is clear that in many cases commissionaire arrangements and similar strategies were put in place primarily in order to erode the taxable base of the state where sales took place. Changes to the wording of Art. 5(5) and 5(6) were therefore considered in order to address such strategies. From a policy perspective, the OECD observed that:

“In general, where the activities that an intermediary exercises in a country are intended to result in the regular provision of goods or services by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary performing these activities in the course of an independent business.”

Action 7 Report thus proposes changes to Art. 5(5) and 5(6) of the OECD MC and its commentary to address BEPS through Commissionaire and similar strategies. The current Art. 5(5) dealing with Agency PE and the version proposed by Action 7 are as:

4.2.1 Comparison between current and proposed Article 5(5)

Existing Article (in OECD MC 2014)	Proposed Article (as per Action 7 Final Report)
<i>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</i>	<i>Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where person is acting in a Contracting State on behalf of an enterprise and, in doing so</i>
<i>...and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise</i>	<i>...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</i> <i>a) In the name of the enterprise, or</i> <i>b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or</i> <i>c) For the provision of services by that enterprise</i>

Existing Article (in OECD MC 2014)	Proposed Article (as per Action 7 Final Report)
<p><i>...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</i></p>	<p><i>...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</i></p>

4.2.2 Principles emanating from the revised scope of Agency PE under Art. 5(5):

- ▶ The scope of Agency PE under Art. 5(5) has thus been expanded. This may be referred to as “Extended Agency PE (EAPE)”. Through this, Action 7 Report proposes to change the current language of Art. 5(5) from “conclusion of contracts in the name of” to additionally include the EAPE rule, i.e., when the agent **habitually plays the principal role leading to the conclusion of contracts** that are **routinely concluded without material modification** by the principal-enterprise.
- ▶ The proposed change highlights substantive conclusion of contracts over the strict legal sanction granted by the FE to the agent. The proposed change thus lowers the PE threshold when compared with the current standard.
- ▶ Focus on activities exercised by person in Source State, which are intended to result in regular conclusion of contracts to be performed by FE, i.e., where the person in Source State acts as sales force of the FE. The thrust here is thus on “substance over form”, where the activity of agent binds the FE to perform by entering into a contract in its own (agent’s) name.
- ▶ The proposed Article has a wider scope to the contracts to which it applies to as well. The contracts may be:
 - ▶ In the name of the foreign enterprise.
 - ▶ For granting of right to use property (including tangible or intangible) in respect of which FE has right to use property.
 - ▶ For the provision of services by FE.
- ▶ EAPE will not apply if the activities are of a PoA nature as described in Art. 5(4).

4.2.3 Principles emanating from the revised commentary on Art. 5(5):

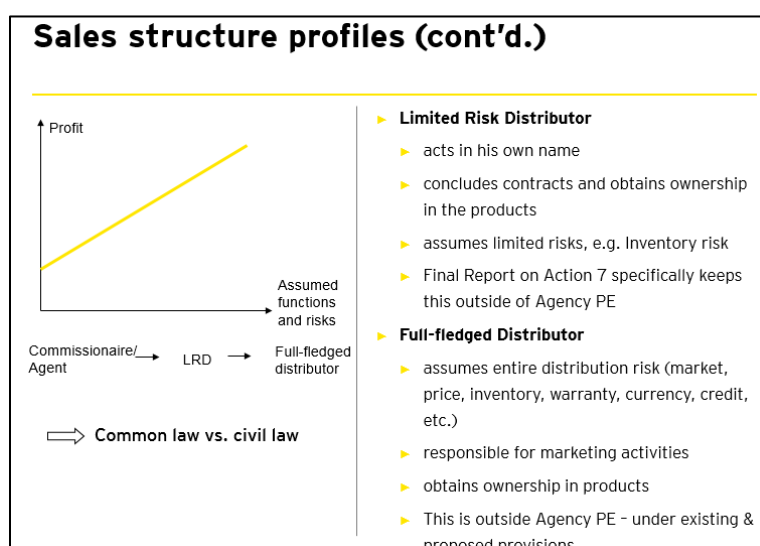
The authors have summarised below at one place, the various principles explained in the proposed commentary on Art. 5(5) in the Action 7 Report.

The commentary reiterates that the nature of agent’s activity (and not the scope of authority of agent) is relevant to determine agency PE.

4.2.3.1 ‘Acting on behalf of’

- ▶ A person is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the state concerned

- ▶ This will be the case, for example, where an agent acts for a principal, where a partner acts for a partnership, where a director acts for a company or where an employee acts for an employer.
- ▶ A person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person.
- ▶ The person acting on behalf of an enterprise can be a company; in that case, the actions of the employees and directors of that company are considered together for the purpose of determining whether and to what extent that company acts on behalf of the enterprise.
- ▶ Distributor (in Source State) who buys products (including from an AE) in his own name, owns the property and resells it does not trigger Agency PE as he does not act on behalf of the FE.



- ▶ Likewise, Agency PE is not triggered when LRD concludes contracts on its own behalf
 - ▶ The transfer of the title to property sold by that “low-risk” distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold) so that the distributor would derive a profit from the sale as opposed to a remuneration in the form, for example, of a commission.
- ▶ The proposed revised Art. 5 applies not only to contracts that create rights and obligations that are legally enforceable between the enterprise on behalf of which the person is acting and the third parties with which these contracts are concluded, but also to contracts that create obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.
 - ▶ A typical case covered by these subparagraphs is where contracts are concluded with clients by an agent, a partner or an employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and these clients.

4.2.3.2 'Concludes contracts'

- ▶ The context of “concludes contracts” covers situations where a contract is considered to have been concluded by a person under the relevant law governing contracts in that country.
- ▶ A contract may be concluded without any active negotiation of terms.

- ▶ For example, where the relevant law provides that a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise.
- ▶ A contract may, under the relevant law, be concluded in a state even if that contract is signed outside that state.
 - ▶ For example, the conclusion of a contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside that state.
 - ▶ A person who negotiates in a state all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that state even if that contract is signed by another person outside that state.

4.2.3.3 'Such activities need to be done habitually'

- ▶ Scope of "habitually" has been retained from that appearing in the existing commentary at paragraph 33.1, which reiterates that it is something more than mere transitory.
- ▶ This needs to be tested based on facts of each case and no precise frequency test is possible to test the condition of "habitually".

4.2.3.4 'Principal role leading to conclusion of contracts without material modification'

- ▶ This aspect is discussed in greater detail below in the subsequent paragraph dealing with impact of Action 7 on marketing and selling activities.

4.2.3.5 'In the name of'

- ▶ The reference to contracts "in the name of" in subparagraph (a) does not restrict the application of the subparagraph to contracts that are literally in the name of the enterprise; it may apply, for example, to certain situations where the name of the enterprise is undisclosed in a written contract.

4.2.4 Exclusions from Extended Agency PE (EAPE) rule

Whilst this explains what is covered within the expanded scope of the proposed Agency PE rule, it may be understood that the following may be excluded from the scope of EAPE:

- ▶ Principal to principal (P2P) activities; LRD arrangements in particular.
- ▶ Contract manufacturing arrangements, unless specifically covered by the relevant treaty.
- ▶ Support activities provided by Business Process Outsourcing (BPO) or Knowledge Process Outsourcing (KPO) (such as call centre for dismantling information, contract research) may not fall within EAPE.
- ▶ Mere promotion and marketing of goods in a way that does not directly result in conclusion of contract.

The scope of revision is thus extremely relevant since more and more arrangements are likely to get covered with the ambit of Agency PE. One needs to analyse the facts of each case in great detail, review the scope of activities performed by the agent in the Source State, documentation giving authority or narrating scope of functions of the agent etc. to determine the relationship between the parties and conclude on EAPE trigger.

4.3 Action 7 proposals introduce the EAPE Rule covering agent's activities directly resulting in contract conclusion. How would the

EAPE Rule impact arrangements where sales and marketing activities are undertaken in Singapore and the contract is fulfilled by the FE outside Singapore?

Under Action 7 proposals on Agency PE at Art. 5(5), the EAPE Rule covers situations where an entity “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”. As per the proposed commentary on the EAPE Rule [paragraphs 32.5, 32.6 of Action 7 Report], the scope of EAPE Rule is explained below:

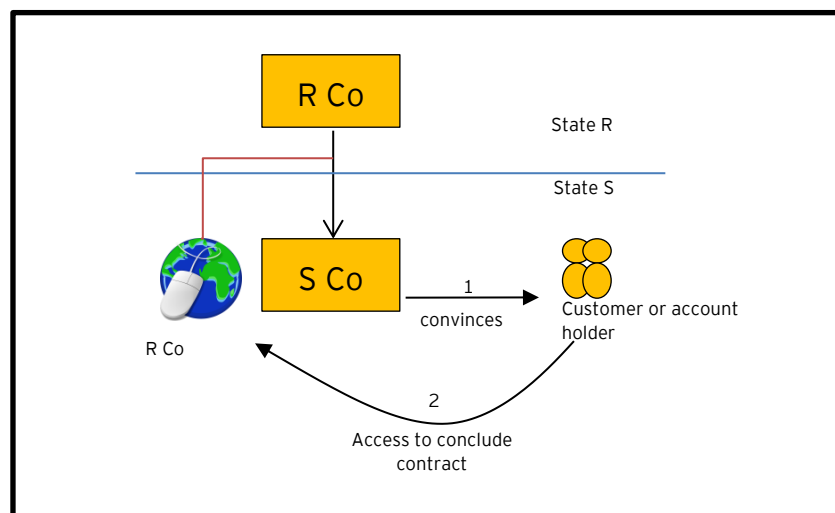
- ▶ The EAPE Rule intends to include arrangements where the conclusion of a contract **directly results** from the actions that a person performs in a Source State on behalf of the principal, though the contract is not concluded by the person in that state.
- ▶ The test focuses on **substantive activities** directly resulting in conclusion of contracts for FE. It is synced to the persons who habitually play the principal role in conclusion of contracts, which is linked to the sales force, persons who actually approach and convince the customer, notwithstanding lack of actual authority with the agent to conclude the contact.
- ▶ Typically associated with actions of the person who “**convinced**” the third party to enter into a contract with the FE.
- ▶ Activities must be tested in light of the object and purpose of paragraph 5, which is to cover cases where the activities of the person are **intended** to result in the **regular conclusion** of contracts being performed by the FE.
- ▶ The exercise is a fact sensitive one and must be determined on the basis of the commercial realities of the situation.
- ▶ Presence of such a person must be more than mere transitory; the extent and frequency of qualifying activity will depend upon the nature of the contracts and business of the principal.

4.3.1 Discussion concerning sales and marketing activities

- i. What may be specifically examined are sales and marketing activities, which are crucial to the FE’s business and revenues in the Source State, though the actual contract is fulfilled by the FE, i.e., contract may be concluded by action and conduct without formal paper acceptance. It is not uncommon for MNE groups to have sales and marketing offices or personnel across countries that facilitate sales of the FE. Such agents may or may not have an authority to conclude contracts. Under the EAPE rule proposed by the OECD, an arrangement where a MNE has sales and marketing offices in the Source State may constitute a PE in certain circumstances.
- ii. The following discussions are given in the Action 7 Report on sales or marketing function:
 - ▶ Actions of dependant agent (DA) should go beyond mere promotion or advertising and result in conclusion of contracts.
 - ▶ EAPE Rule does not apply where:
 - ▶ A person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts.
 - ▶ Representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs. (Such marketing activity does not directly result in the conclusion of contracts between the

doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity.)

- ▶ Mere participation in the negotiation insufficient to say that agent has concluded contracts or played a principal role leading to conclusion of contracts (however, this may be a relevant factor in determining the exact functions performed by that person on behalf of the FE.)
- ▶ Examples in the Action 7 Report resulting in PE:
 - ▶ A person solicits and receives (but does not formally finalise) orders that are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions.
 - ▶ Example on online distribution at paragraph 32.6 of the report:



Facts:

- ▶ R Co, a company resident of State R, distributes various products and services worldwide through its websites.
- ▶ S Co, a company resident of State S, is a wholly-owned subsidiary of R Co.
- ▶ S Co's employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy R Co's products and services and are therefore responsible for large accounts in State S.
- ▶ S Co's employees, whose remuneration is partially based on the revenues derived by R Co from the holders of these accounts, use their relationship-building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by R Co.
- ▶ When one of these account holders is persuaded by an employee of S Co to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with R Co before the goods or services can be provided by R Co and explains the standard terms of R Co's contracts, including the fixed price structure used by R Co, which the employee is not authorised to modify.
- ▶ The account holder subsequently concludes that contract online for the quantity **discussed** with S Co's employee and in accordance with the price structure presented by that employee.

Technical analysis

- ▶ In this example, S Co's employees play the principal role leading to the conclusion of the contract between the account holder and R Co and such contracts are routinely concluded without material modification by the enterprise. The fact that S Co's employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and R Co.

4.3.2 Impact of EAPE Rule on sales or marketing function - Analysis

- Whilst the proposed EAPE Rule will cover those situations where agents play a principal role leading to routine conclusion of the contract without material modification, the scope becomes obscure in view of subjectivity involved in interpretation of the phrase. The test, being highly fact sensitive and subjective, depends upon the fact pattern involved in each case, and no straitjacket checklist can be drawn up to determine which activities are sensitive to PE and those which are safe.
- It can be inferred that where actions of the sales force directly result in regular conclusion of contracts, a PE may emerge even though such sales force has no actual authority for conclusion of contracts on behalf of the FE. The aim of OECD is to ensure that an Agency PE exists not only in contacts that create rights and obligations that are legally enforceable between the FE and the customers, but also to contracts that will effectively be performed by the FE rather than by the person contractually obliged to do so.
- Meaning of "principal role"** - the term "principal role" can be understood to mean¹⁶ "the first order of importance" ; "main, most important, consequential, or influential". Thus, the agent must perform the "main" activities which lead to the conclusion of contracts. Activities which play a part in increasing sales or revenues for the FE, may not be relevant if they are otherwise of a supporting nature, PoA nature, or do not result in "conclusion of contract" by the FE.
- Scope of the term "directly results"**

The proposed commentary on the EAPE rule, as explained above, requires that conclusion of a contract that "**directly results**" from the actions that a person performs in a state on behalf of the principal. Emphasis is on the term "directly results".

- ▶ The term "direct" means¹⁷ "in a direct line or manner; straight, without anyone or anything intervening or in between; at once; instantly."
- ▶ The term "results" means¹⁸ "a thing that is caused or produced by something else"; "a consequence or outcome"; "occur or follow as the consequence of something".

Hence, this may mean that the agent has to perform such activities that, **directly lead to the consequence of a contract being concluded, without further interference by any other entity or person. The actions of the agent are sufficient and all that are required for the conclusion of a contract between the customer and the FE.**

In other words, according to the authors, activities that by themselves do not necessarily result into the possibility of a contract being concluded, may not be relevant in this regard.

¹⁶ <https://en.oxforddictionaries.com>

¹⁷ <https://en.oxforddictionaries.com>

¹⁸ Same as above

Thus, for example, mere marketing or advertising on behalf of the FE may not be relevant, if the same does not consist of or be followed by activities that “directly results” in the conclusion of a contract between the third party and the FE. Even though such marketing and advertising activities may lead to the promotion of sales and increase in revenues, these may be considered at best as “indirect” in nature. What is relevant for this purpose is an activity, which may straight culminate into a contract being concluded without further intervention by any other person.

Thus, the term “directly result” appears to narrow down the general understanding of the proposed amendment. Not every case of a marketing or sales promotion or advertising or presence of sales personnel may be covered by the EAPE rule; what is required to create a PE are activities directly resulting into conclusion of contracts for the FE.

- v. Thus, the requirement of the contract being in the name of enterprise becomes academic in a post-BEPS era.
- vi. Post-BEPS, the expression “conclusion of contract” would not mean completion or execution of contract, but refers to entering into the contract. It refers to conclusion of the terms and conditions upon which the contract is to be eventually executed. This is also borne out by the expression that the contract may need to be “for the transfer of ownership of goods belonging to the enterprise” or “for the provision of services by that enterprise”. Thus, the clause refers to a stage of conclusion of contract where the goods belonging to the enterprise are yet to be delivered or the services are yet to be performed by the enterprise.
- vii. A question may arise in cases of repetitive approaches by a foreign principal to a Singapore customer without involving the Singaporean agent (who might have played principal role in convincing the Singaporean customer when he placed the first order). For example, the Singaporean agent strived hard to convince the customer that it should buy a certain make of the computer from foreign enterprise. In Year 1, the imports may have been concluded through the instrumentality of Singaporean agent. Being satisfied with the product, at the stage of expansion, the orders may have been placed by the Singaporean customer directly without involving the Singaporean agent. A question arises as to whether the agent is deemed to have played any role in convincing the customer in Year 2 or thereafter.

4.4 What are Action 7 proposals in relation with Agency PE for contracts with “standard terms”? How is Agency PE exposure in terms of standard contracts presently evaluated?

4.4.1 Current treatment of “standard contracts”

Under the current OECD Model, Agency PE is created based on the formal conclusion of contracts. Hence, if the dependent agent has a formal authority to conclude contracts and should he “habitually” exercise such authority, then an Agency PE will be constituted.

i. Commentaries

Commentaries by Prof Klaus Vogel and Arvind Skaar indicate that extremely restricted authority or a situation where terms are pre-decided by the principal may not be sufficient to trigger agency PE rule under legacy PE rules, as the agent may not be regarded as having effective authority to negotiate and conclude the contract.

- ▶ Klaus Vogel in his commentary on Double Taxation Conventions (3rd Edition, page 339) stated that “a general authority cannot be taken to exist if the authority to negotiate and conclude contracts is so restricted that it allows the agent or employee to settle for only

such prices and terms and conditions as were fixed in advance by his principal, the agent or employee having no scope for decisions of his own in this respect...".

- ▶ Arvid Skaar in his book on Permanent Establishment (page 496-497) stated that "...in principle, limitation of authority may be so radical with respect to the operations of the enterprise that the power exercised cannot reasonably be classified as an "authority". It might be more appropriate in such cases to call the "agent" a messenger. Thus, it has been argued in US tax-treaty doctrine that **no agency PE is constituted when the authority is limited to fixed prices and other fixed conditions determined by the principal, even if the contract is concluded by the agent**. Accordingly, the 1946 treaty between Australia and the UK expressly exempts an agent who concludes contracts under fixed prices determined by the principal from being an agency PE".

ii. Judicial interpretation - A liberal approach

There appears to be limited guidance from the judiciary on this aspect. The following international case law indicates a liberal approach adopted by Courts leading to an inference that PE may emerge by equating a limited authority to dependent agent to conclude contract as per instructions or terms set by the foreign principal, as the authority to conclude contracts in certain circumstances.

- ▶ In the case of Dell Products v. Tax East [HR-2011-02245-A], Court of Appeal observed that a **functional-realistic approach** should be endorsed rather than a literal-formalistic approach in interpreting the words "authority to conclude contracts in the name of the enterprise" in Art. 5(5) of the treaty. This is because if it were understood otherwise, it would be too easy to avoid the principle of source taxation where a mere establishment of a commission relationship would result in source taxation being avoided even though the financial and legal attachment between the agent and principal was strong and even though in reality, the taxpayer is bound by the agent. In the present case, the taxpayer was considered to have a PE in Norway by virtue of Dell AS (its agent) having authority to conclude a standard term contract with customers in Norway on behalf of the taxpayer. The Court observed that the taxpayer is, in reality, bound by the agent, considering that:
 - ▶ All sales were made under the Dell trademark and on standard terms and conditions.
 - ▶ The taxpayer accepted, without review, all of the sales concluded by the agent.
 - ▶ The taxpayer would not refuse to deliver goods to the ultimate customers even if Dell AS exceeded its authority.

(The above ruling was later reversed by the SC of Norway since the agent was a commissionaire who did not enter into the contracts in the name of the principal. However, the SC did not discuss on the aspect of the standard contracts.)

- ▶ In a Dutch ruling, in the case of Air Insurance Agent (Hoge Raad case No. 16,445 dated 13 January 1971), a US-based air insurance company appointed an agent in the Netherlands to sell insurance policies to customers in the Netherlands. The agent collected insurance premiums from the passengers and signed the standard termed insurance policies on behalf of the US company. The SC of Netherlands held that a Netherland insurance agent, having general authority to conclude standard contracts on behalf of the US insurance company, is to be regarded as dependent agent of the US company. It is not necessary that the agent had to negotiate the insurance contracts with the customers so as to be regarded as "concluding contracts on behalf of" the US company.

- ▶ In an Israeli ruling, the tax authority held that the Israeli agent who solicited clients in Israel to sign standard agreements provided by the FE created agency PE of the FE. The tax authority was of the opinion that the agent had the authority to conclude contracts on behalf of the FE on the basis that the agent was *in essence* authorised¹⁹.
- ▶ In a case dealt by the Italian SC²⁰, a Swiss tax resident authorised an Italian tax resident to sign contracts without any authority to make decision or to negotiate contracts on behalf of the Swiss company. The SC of Italy held that the mere fact of granting power of attorney to the individual was sufficient to create Agency PE and it did not matter that the Italian tax resident merely signed contracts on the basis of instructions provided by the Swiss company. The SC also stated that in the Italian interpretation of the term, evidence of the existence of an agency PE can also be inferred when: (a) the agent, although having representative powers, has no decision power over the terms of the contracts concluded in the name of the FE, (b) he participates in negotiations, even if he has no representative powers.

4.4.2 BEPS Action 7 Proposals in relation to “standard contracts”

Action 7 Final Report proposes changes to the OECD commentary on Art. 5(5). The proposed commentary on Agency PE explains the following in relation with “standard contracts”.

- ▶ **Conclusion of standard contracts:** acceptance of contracts signed on standard terms, without active negotiation leads to “conclusion” of contract by the taxpayer itself if provided under the law governing contracts. This reference to contract law is perhaps to the law of the country where such contract is accepted (the Source State). Extracts of proposed commentary (paragraph 32.4):

“The phrase ‘concludes contracts’ focuses on situations where, under the relevant law governing contracts, a contract is considered to have been concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract; this would be the case, for example, where the relevant law provides that a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise...”

Application of the EAPE Rule to cover “standard contracts”: proposed commentary on paragraph 32.5 explains that the EAPE Rule aims to cover situations where substantive activities directly result in conclusion of contracts even though such conclusion takes place outside Source State. Such substantive activities are typically associated with actions of person who convinced the third person to enter into a contract with the FE. In terms of standard contracts for online distribution, an example is provided in Action 7 Report (in proposed paragraph 32.6) (discussed above at 4.3.1) in which Agency PE is created where buyers are convinced to enter into standard contracts from Source State, even though the same are signed outside Source State. The example highlights the activities undertaken by employees of a subsidiary in Source State to convince buyers to enter into contracts with a taxpayer in resident state, which include explaining terms of standard contracts, convincing them to enter into the contract, maintaining relationships etc.

4.4.3 Conclusion - is the current scenario rather favourable?

Even in the current scenario, there are instances where conclusion of standard contracts is not outright excluded from Agency PE trigger by the Courts. However, a distinction needs to be made

¹⁹ Source : Taxmann’s book on PE - authored by Ashish Karundia (Page 272)

²⁰ Case No. 8488, 9 April 2010 (Corte Suprema di Cassazione)

on the current criteria of “authority to conclude contract”, [which is present under the existing as well as proposed Art. 5(5)] and the proposed criteria, i.e., “principal role, which results in routine conclusion of contract without material modification” [to be included in proposed Art. 5(5)]. Presently, for evaluating the test of formal “conclusion of contract”, it may be possible to suggest (depending on the facts) that there is no effective authority exercised if the agent does what he is asked to do in terms of a standard contract whilst the principal has a right to review. However, as aforesaid, this is not infallible and there has been debate whether conclusion of standard contracts also amounts to exercise of authority to conclude contract, triggering Agency PE.

On the other hand, under Action 7 proposals, in line with the “principal role” test of the EAPE rule, routine conclusion of standard terms contract may result in a PE (as illustrated under paragraph 32.6 of proposed commentary). Hence, exposure under proposed Art. 5(5) appears to be wider so as to cover conclusion of standard term contracts within the ambit of Agency PE. Whether activities of an agent in Singapore in relation to “standard contracts” results in an Agency PE will depend on the nature and significance of the agent’s activities and the manner of conclusion of contracts.

Further, the criteria of authority to conclude contracts is wide enough to cover within its scope, contracts in relation to provision of services, licensing or transfer of IP by the foreign principal to the third party. Under Action 7 proposals, the EAPE rule explicitly clarifies this proposition.

4.5 What would be the impact of Action 7 proposals relating to Agency PE [Article 5(5)] under the existing Singapore treaties?

As analysed above, the proposed Art. 5(5) widens the scope of the existing Agency PE rules.

However, various Singapore treaties already contain a lower threshold for Agency PEs. Further, several Singapore treaties are based on the UN Model (including securing orders, almost wholly condition for independent agent etc.). Since the widening is compared to OECD Agency PE rule, the actual tax treaties may not necessarily have widening impact. In fact, as discussed herein, unless a suitable carve-out is made, implementation of BEPS Action through the MLI, may have impact of narrowing down some of the existing Singapore treaties in certain respects.

In this regard, impact of Action 7 proposals on the Agency PE clause of various Singapore treaties is discussed hereunder.

4.5.1 OECD-patterned treaties:

Illustratively, Singapore’s tax treaties with China, Cyprus, Israel, Japan, South Africa, Sri Lanka etc. is based on the OECD Model of Art. 5(5).

Typically, these treaties would read , in comparison to the proposed Action 7 version of Art. 5(5), as follows:

OECD MC	BEPS Action 7
<p><i>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</i></p>	<p><i>5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and in doing so, habitually concludes contracts, or 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:</i></p>

OECD MC	BEPS Action 7
<p><i>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</i></p>	<p><i>a) In the name of the enterprise, or</i></p> <p><i>b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use</i></p> <p><i>c) For the provision of services by that enterprise</i></p> <p><i>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</i></p>

The above treaties are likely to be impacted if the proposed Art. 5(5) is implemented therein. Proposed Art. 5(5) has a wider scope of Agency PE and such treaties (which are based on the OECD Model) will be impacted as discussed in the earlier paragraphs. To summarise:

- ▶ The proposed Art. 5(5) will continue to include authority to include contracts. Even if there is no authority, a person who plays principal role leading to orders concluded by FE routinely (usually, for standard goods or services), there is a PE in relation to activities in Singapore.
- ▶ As mentioned above, commissionaire arrangements may not be too relevant in common law countries. However, with the specific amendment to Art. 5 as above, substance-based analysis may become more relevant and intense in view of BEPS Action 7 proposals.
- ▶ The existing Agency PE rule already extends to all forms of business contracts that are habitually concluded by the agent. The proposed Art. 5(5) makes it expressly clear that the contract may relate to any property, services etc.

4.5.2 Treaties with stock maintenance and delivery agents

Singapore's tax treaties with some countries contains a "stock maintenance and delivery" rule, i.e., an Agency PE will be constituted if the dependent agent habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the FE. Illustratively, this is found in Singapore's treaties with Republic of Korea, Hungary, Netherlands, etc.

Typically, these treaties would read as under, in comparison to the proposed Action 7 version of Art. 5(5):

OECD MC	BEPS Action 7
<p><i>5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to</i></p>	<p><i>5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a</i></p>

<p><i>whom paragraph 6 applies - is acting in one of the states, on behalf of an enterprise of the other state, that enterprise shall be deemed to have a permanent establishment in the first-mentioned state if:</i></p> <p><i>(a) He has and habitually exercises in that state an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise</i></p> <p><i>(b) He has no such authority, but habitually maintains in the first-mentioned state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise</i></p>	<p><i>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:</i></p> <p><i>a) In the name of the enterprise</i></p> <p><i>b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use</i></p> <p><i>c) For the provision of services by that enterprise that enterprise shall be deemed to have a permanent establishment in that state in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph</i></p>
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Art. 5(5) under current treaties is thus wider as compared to the OECD-patterned treaty. Even in the absence of an authority to conclude contract for the FE, an agent who habitually maintains a stock of goods or merchandise, which he regularly delivers on behalf of the FE constitute PE of the FE in Singapore is covered.

It needs to be examined whether the activity of stock maintenance and regular delivery would fall under the proposed Art. 5(5) of Action 7 Report. Typically, the activity of maintaining stock of goods and delivering the same to customers in the Source State is unconnected with the task of “habitually concluding contracts” or “habitually playing a principal role leading to the conclusion of contracts without material modification”. It is an independent activity, generally undertaken after conclusion of contracts.

Hence, unless the activity of stock maintenance and delivery results in contract conclusion, these treaties can be considered as wider as compared to Action 7 proposals. Implementation of proposed Art. 5(5), if done through the MLI, can have an effect of narrowing Art. 5(5) of above treaties unless a specific carve out for such treaties is made.

4.5.3 Treaties with ‘securing orders’ rule in Agency PE

Singapore’s tax treaties with countries such as Australia, India, Thailand, Finland etc. contain a “securing orders” rule, which means that an Agency PE will be constituted if the agent habitually secures orders in the Source State for the principal. Some of these treaties also include habitually securing orders for common controlled entities.

Typically, these treaties would read, in comparison to the proposed Action 7 version of Art. 5(5), as follow:

OECD MC	BEPS Action 7
<p>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 in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:</p> <p>(a) Has and habitually exercises in that state an authority to conclude contracts in the name of 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</p> <p>(b) Has no such authority, but habitually maintains in the first-mentioned state a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise</p> <p>(c) Habitually secures orders in the first-mentioned state, wholly or almost wholly for the enterprise itself... or for the enterprise and other enterprises controlling or controlled by, or subject to common control, as that enterprise</p>	<p>5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and in doing so, habitually concludes contracts, or 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:</p> <p>a) In the name of the enterprise, or</p> <p>b) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use,</p> <p>c) For the provision of services by that enterprise</p> <p>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</p>

The above treaties are based on the UN Model and are thus broader as compared to the OECD version, since even in the absence of an authority to conclude contract for the FE, an agent who habitually “secures orders” for the FE (or related enterprise) constitutes PE of the FE in Singapore.

Before analysing the impact on such treaties, it is necessary to understand the meaning of the term “securing orders” used in these treaties.

- ▶ This clause finds roots in the UN MC. As per the UN MC and the commentary thereto, this paragraph is broader in scope than paragraph 5 of the OECD MC. According to the UN, this clause was necessary because it restricted the type of agent who would be deemed to create a PE of a non-resident enterprise, exposing it to taxation in the source country. Some members from developing countries pointed out that a narrow formula (as the one in the OECD MC) might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf²¹.
- ▶ The Group of Experts on International Cooperation in Tax Matters understood that paragraph 5, subparagraph (b) was to be interpreted such that if all the sales-related activities take place

²¹ Paragraph 24 of commentary on Art. 5, UN Model, 1999 and 2001 versions

outside the host state and only delivery, by an agent, takes place there, such a situation would not lead to a PE. However, if sales-related activities (e.g., advertising or promotion) are also conducted in that state on behalf of the non-resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a PE may exist²². It appears that the UN envisaged and was trying to tackle the issue, which the OECD is now trying to address under BEPS Action 7, with the focus being on sales-related activities.

- ▶ There is not much guidance on interpretation of the term "securing orders" as used in the tax treaty. Hence, having regard to the principles of tax treaty interpretation, the term would need to be given its ordinary or natural meaning. Ordinary meaning of "securing" could mean safety and certainty of order. Securing order therefore could mean either obtaining an order or where there is a certainty to obtain an order. Therefore, those activities of a service provider or agent that result in ensuring or making certain or sure that the foreign principal gets an order for sale or supply of goods could fall within the scope of the provision. It is difficult to postulate in abstract terms as to what can be considered in securing orders and much depends on the facts of every specific case.
- ▶ Some guidance can be found in other international tax treaties. For example, the Protocol to USA - India tax treaty describes the meaning of "securing orders". Of course, the same is not binding on other treaties, nor does it become an absolute authority, but one can refer to it for interpretational guidance. The Protocol lays down the following conditions for the agent "securing orders" condition to be fulfilled:
 - ▶ Such person frequently accepts orders for goods or merchandise on behalf of the enterprise.
 - ▶ Substantially all of such person's sales related activities in the Contracting State consist of activities for the enterprise.
 - ▶ Such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order.
 - ▶ The enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.
- ▶ It may be noted that Prof. Klaus Vogel in his commentary on Double Taxation Conventions [3rd edition - m.no. 155 - 157 regarding Art. 5(5)] appears to take a fairly wide interpretation of the term. As may be discerned in the below text, the author seems to suggest that mere soliciting orders could be sufficient for the agency PE rule to apply. Solicitation is a broader term since it merely involves trying to obtain or seek an opportunity for a contract and does not necessarily enter into an arrangement, which becomes binding on the parties and the principal.

*"A permanent establishment is created by an agent who habitually **secures orders** wholly or almost wholly for the enterprise itself; or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it, viz. a **dependent exclusive, order-securing agent**. This results in a considerable extension of the permanent establishment concept, since here the employees of a foreign enterprise or persons acting on behalf of a specific enterprise or group of enterprises would already be deemed to constitute a permanent establishment merely by soliciting orders for such enterprise or group of enterprises. One condition however is that the orders involved, rather than being isolated ones, must be secured with a certain regularity... Such rules **undermine the permanent***

²² Paragraph 25 of commentary on Art. 5, UN Model, 1999 and 2001 versions

establishment concept and, as a result, virtually every transaction beyond a simple shipment of goods may lead to a permanent establishment. The term 'permanent establishment' is thus completely deprived of its original contents. Fortunately, international treaty practice has at least so far refrained from adopting similar arrangements, which could have undesirable effects on cross-frontier business relations."

- ▶ Thus, there can be two views on the interpretation of the term. One view advocates that "securing orders" is to be understood in its ordinary meaning, i.e., those activities that result in ensuring or making certain that the FE gets an order for sale or supply of goods. The second view states that "securing orders" may be understood widely to include solicitation of orders.
- ▶ With regards to the discussion above, the interpretation of "securing orders" would need to be accorded its ordinary meaning. The activities of the agent, which result in giving comfort to the principal on certainty of procuring an order for sale or supply of goods, could result in the clause being triggered. However, in the absence of specific guidance, the possibility of courts considering even "solicitation of orders" as being covered by this clause, cannot be ruled out (especially in view of Klaus Vogel's commentary and the consideration that courts sometimes give to the commentary whilst interpreting tax treaties). Whilst at a conceptual or theoretical level, one may try to make a distinction between soliciting orders and securing orders; in practice, it may be a line that can be difficult to draw and the distinction may really be quite unclear.
- ▶ The proposed commentary to Art. 5(5) states that the EAPE rule "habitually playing a principal role leading to the conclusion of contracts without material modification" includes securing and solicitation of orders. Refer the following extracts from the Action 7 report:

"The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The phrase therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. It does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts."
- ▶ Thus, solicitation and receipt seems to be covered within the scope of EAPE, if it gets virtually executed due to routine approval. To this extent, treaties having the "securing orders" rule are already having a wider Art. 5(5) than Action 7 recommendations and hence, may not be, or may only be marginally impacted by implementation of Action 7 proposals.

4.5.4 Manufacturing or processing agents

Some tax treaties, illustratively the Singapore - Australia treaty, contain an additional clause in the Agency PE rule, which trigger Agency PE for an agent who manufactures goods in the Source State for the principal. The clause reads as follows:

"(d) In so acting, he manufactures or processes in that state for the enterprise goods or merchandise belonging to the enterprise."

Similar to "maintaining stock and delivery" agents above, the activity of manufacturing or processing goods belonging to the FE in the Source State is unconnected with the task of "habitually concluding contracts" or "habitually playing a principal role leading to the conclusion of contracts without material modification". Hence, the conclusion above equally applies to the above treaties for this clause. That is, post-Action 7 proposals, such processing or manufacturing may no

longer constitute Agency PE for the FE in the Source State, if the MLI overrides the existing treaties. Alternatively, a carve-out may be required in the MLI if the intent is to avoid narrowing down of the scope of these provisions.

Summary of impact

Classifications	Illustrative treaties	Impact of Action 7 proposals
Art. 5(5)		
OECD-patterned treaties	China, Cyprus, Israel, Japan	High impact: expanded rule
Treaties with securing orders	Australia, India, Thailand	Moderate impact: existing scope wide enough
Treaties with Maintenance Stock and Delivery rule, manufacturing or processing rule	Republic of Korea, Hungary, Netherlands, Australia etc.	Impact depending on how treaties are amended, could be moderate to high if this condition is retained

4.6 Impact on business models and supply chains

Multinational enterprises with global operations may need to review their existing operational structures and practices, particularly but not limited to their sales and marketing function. As outlined previously, commissionaire arrangements have been considered in several court cases in countries such as France, Italy, Norway and Spain with varying outcomes. The two main aspects of such arrangements in the PE discussion are (i) whether the commissionaire creates a PE for the FE or principal through its activities that bind the principal to third parties either economically or legally (as outlined in this chapter); and (ii) whether the commissionaire is legally or economically dependent on the principal. The latter is discussed in greater detail in the next chapter of this document.

Depending on the level of exposure, there is a range of alternate strategies that may be examined and discussed depending on the facts of the specific company. The following outlines a summary of the common options to be taken into consideration:

- ▶ The most straightforward approach seems to be the move from commissionaires and commission agents to distributors. A number of companies consider this as the most practical solution in view of the intense focus on commissionaire structures. However this switch may not be easy in practice, not least because more local infrastructure such as systems and registrations may be required to service a distributor model.
- ▶ In certain cases, a marketing service or customer service arrangement also makes more sense, particularly in cases where the local operating company is providing only limited services to the related selling party or where a group is making initial investment into a market.
- ▶ In some instances, systems limitations would not allow for buy or sell arrangements for a FE in the local markets. The modification of systems is often prohibitively expensive. In such cases, companies typically tend not to make any changes to the agency arrangements; however they would plan on monitoring the environment to determine whether changes will be necessary in the future.
- ▶ The management of cross-border sales teams will need to be more rigorous as it becomes more important to implement strict guidelines for how employees of both the principal and the local entity should act under the centralised model. An example would be the authority of specific

roles to decide on pricing, discounts or changes to terms and conditions, as well as where these activities can take place.

- ▶ A few companies have decided to acknowledge a PE (based on the impact of the proposed OECD changes on their current operating model) and, where it is possible to cover PE profit, pursue an Advance Pricing Agreement (APA) to proactively determine the profit attributable to the PE in view of the increasing amount of uncertainty related to Action 7 and BEPS overall.

Before a company would consider changing its operating model, it should be assessed which distribution model best fits the group strategy as there might be significant commercial advantages of one model compared to others.

As outlined above, the most common approach would be the shift to distributor structures where the existing business model includes commissionaire or agency arrangements. In the OECD's final report on Action 7, it is clear that where a person (including a distributor), concludes contracts on its own behalf and, in order to perform the obligations deriving from those contracts, buys goods from other enterprises and sells such goods to its customers, is not regarded as an agent regardless of how long that person would own title to those goods.

If a company decides to move to a distributor model, it is not a task that should be underestimated as ERP systems, inventory accounting, bad debt handling and many other items will be impacted. The following outlines some examples of potential impact:

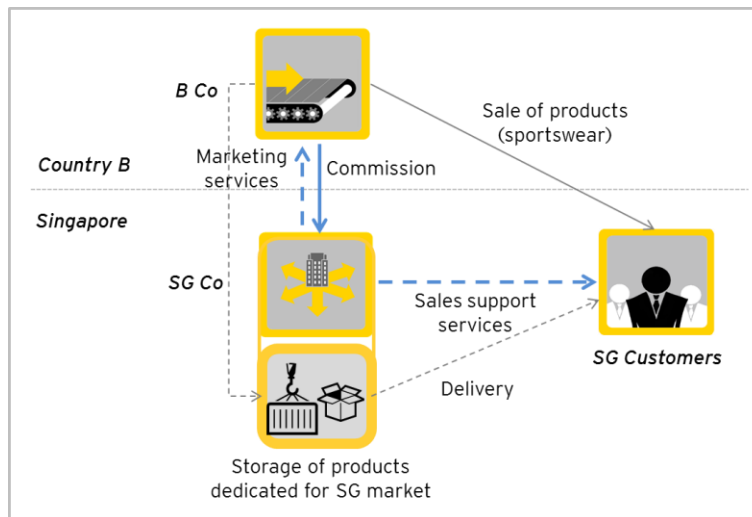
- ▶ The group should review its ERP system logic to judge whether it requires amendments in the rules that determine the booking, reporting and invoicing of the transactions between principal or foreign entity, sales entity and customer.
- ▶ The legal agreements between the group companies have to change to reflect the new operating model, i.e., existing agreements need to be terminated (under considerations of respective notification periods) and new agreements put in place.
- ▶ The intercompany pricing needs to be reviewed and potentially amended.

The above are just a few points that need to be considered in such a change of the distribution model. A careful assessment would be necessary depending on the specifics of the company group in case such a change is envisaged.

Finally, it is to be noted that the final OECD Report does indicate that LRDs will be looked at in further work under Action 9 regarding Risks and Capital. Hence, operating models using LRDs will need to be mindful of the principles and requirements that could be part of such a review. In addition, companies need to be mindful of how these rules work in conjunction with the new anti-fragmentation rule discussed in the previous section.

4.7 Case studies

4.7.1 Sales and marketing activities carried out in another state with support from a local subsidiary



Facts and business model:

- ▶ B Co is a manufacturer of sportswear, based in country B, whereby its entire manufacturing function is performed in that country.
- ▶ SG Co, a 100% subsidiary of B Co, does not perform any manufacturing or processing functions. The company has 100 employees who carry the responsibility to actively market and advertise B Co's products in Singapore. In addition, it provides support services to customers in Singapore.
 - ▶ SG Co is remunerated on a percentage-of-sales commission basis.
 - ▶ The activities performed by SG Co primarily include:
 - ▶ Identifying customers (e.g., retailers), market research.
 - ▶ Localisation of the marketing strategy set by B Co for the Singapore market.
 - ▶ Providing information on B Co's products to potential customers.
 - ▶ Pricing of the products based on pricing policies and ranges set by B Co.
 - ▶ Storage of products in its (SG Co's) own warehouse and delivery to customers once sale is made.
 - ▶ Right to amend payment/credit terms, warranties or other terms and conditions.
 - ▶ Other support or call centre services for Singapore customers.
 - ▶ Contracts with customers in Singapore are concluded by B Co. The terms negotiated by SG Co are routinely approved by B Co. Once a customer contract has been finalised by B Co, SG Co directs the customer to B Co to sign and formally conclude the contract as well as provides support with formalities as necessary.

What is the impact of the Action 7 proposals on PE aspects of B Co in Singapore?

A. Current scenario (under OECD-patterned treaty):

- ▶ It could be argued that there is no fixed place PE and Agency PE of B Co in Singapore since SG Co does not have the authority to conclude contracts on behalf of B Co in Singapore.

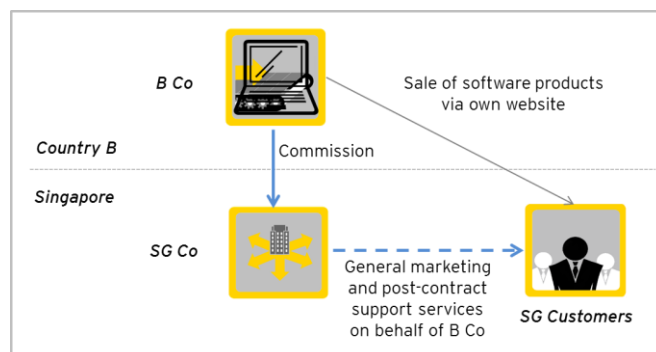
B. PE exposure based on Action 7 proposals:

- ▶ The new Agency PE approach included in the Action 7 proposals includes activities of related companies that contribute to concluding the contract for the supply to local customers directly and to renewing (and adjusting) existing contracts and terms with Singapore customers.
- ▶ SG Co is responsible for the localisation of the group marketing strategy, provides a strong sales force in the market, has the authority to decide on key commercial terms and convince the customers to acquire B Co's products. Even though the contracts are formally concluded by B Co, it can be certainly concluded that SG Co "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise". Based on the proposed OECD commentary, a PE of B Co will be created due to the following:

"The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The phrase therefore applies where, for example, a person solicits and received (but does not formally finalise) orders, which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions."

- ▶ It may be difficult for B Co to argue that the activities are merely support services (i.e., are of PoA nature) since these activities are directly connected to and play a significant role for the sales in Singapore.
- ▶ Based on the above, it is most likely that a PE of B Co in Singapore will be created. This could potentially lead to a higher allocation of overall profit in Singapore compared to the current state (i.e., currently, SG Co's commission fee is the only profit in that transaction that would be subject to corporate taxation in Singapore). Currently, there is uncertainty around how profits will be attributed to such PE; OECD's guidance on profit attribution is expected later in 2016. Where SG Co is already receiving a commission, based on a percentage of sales generated, even more ambiguity is created around the PE profit attribution. This is because compensation is already being received in Singapore that is tied to the sales that are being generated, albeit not by B Co or its PE. The tax authorities may assert that the profits of SG Co are irrelevant when considering the profit attributable to the PE. However in the case of Singapore it is interesting to note that paragraph 14.3 of the Singapore transfer pricing guidelines state that *if the taxpayer receives an arm's length remuneration from its foreign related party that is commensurate with the functions performed, assets used and risks assumed by the taxpayer, there will be no further attribution of profits to the PE and thus, there will be no additional Singapore tax liability for the foreign related party.*

4.7.2 Case study 2: Digital operating models - Sale of software products via own website to customers in another state (with support services performed by a local subsidiary)



Facts and business model:

- ▶ B Co manufactures software products and sells those in various countries, including Singapore, via its own website.
- ▶ Contract terms and prices are negotiated and concluded directly between B Co and the Singapore customers. SG Co has no role to interfere with these terms.
- ▶ SG Co, a 100% subsidiary of B Co, does not own any IP or sales or distribution rights related to B Co's products. It has few employees who carry on general marketing activities and provide support services to customers in Singapore. SG Co is remunerated on a percentage-of-sales commission basis.
- ▶ The dealings between B Co and SG Co are formalised by an intercompany agreement, which specifies respective roles and responsibilities in relation to sales and marketing as well as related sales support services.
- ▶ The functions of SG Co primarily include:
 - ▶ Co-ordinating marketing campaigns in Singapore through print, television and online media, which are part of the global campaigns developed by B Co's marketing team.
 - ▶ Advertising material is designed, altered and approved by B Co before being utilised in Singapore.
 - ▶ SG Co's marketing personnel have regular virtual meetings with the marketing team of B Co to discuss the success of the respective campaigns in Singapore.
 - ▶ The rest of SG Co's staff are responsible for providing routine support services to B Co's Singapore customers, including post-sale issues with orders (e.g., delivery delays, faulty products), coordination of pick-ups for customer returns, resolving of password and login issues.
- ▶ B Co operates and maintains its online website, which is one of its main sales platforms. Although SG Co's staff has access to customer and order details available on B Co's website, SG Co does not have access to alter or modify orders once these have been placed by Singapore customers.

What is the impact of the Action 7 proposals on PE aspects of B Co in Singapore?

A. Current scenario (under OECD-patterned treaty):

- ▶ Arguably, no fixed place PE and no Agency PE of B Co in Singapore due to the following reasons:
 - ▶ SG Co merely performs support services for the group, which qualifies as PoA in nature.
 - ▶ SG Co does not have the authority to conclude contracts on behalf of B Co in Singapore.

B. PE exposure based on Action 7 proposals:

- ▶ The activities carried on by SG Co are pure support or liaison activities, which do not include approaching of customers or lead to the conclusion of contracts or solicitation of orders.
- ▶ Marketing and advertising activities are determined by the foreign parent company with no discretion to SG Co with respect to the marketing strategy or the terms and conditions included in the customer contracts.
- ▶ Based on the OECD Report on Action 7, a mere promotion and marketing function that does not directly result in conclusion of contracts may not constitute a PE. Furthermore, the report provides a similar example related to representative of a pharmaceutical company promoting drugs (i.e., PE is not created due to the representative's contacts with doctors since such marketing activities do not directly result in the conclusion of contracts with patients).
- ▶ In addition, the report states that the mere participation in contract negotiation is insufficient to say that an agent concluded contracts or even played a principal role leading to the conclusion of contracts.
- ▶ Based on the above, it is likely that the above arrangement may not be adversely impacted by the proposed Action 7 changes.

5. Modification of Art. 5(6) (Independent Agents)

5.1 What are the BEPS Action 7 proposals regarding Independent Agents under Article 5(6) of the current OECD Model Convention?

5.1.1 Comparing the amendments

Art. 5(6) under existing OECD MC excludes independent agents from the scope of Art. 5(5) on Agency PE. The Action 7 Report identifies commissionaire arrangements as one of the key reforms in the Agency PE rule as discussed in the previous chapter. Along with this, it also seeks to tighten the exclusion from Agency PE for Independent Agents.

The Action 7 Report proposes to amend the existing Art. 5(6) of the OECD MC as below:

Existing Article 5(6)	Proposed Article 5(6)
<i>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</i>	<i>a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned state as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.</i> <i>b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50% of the beneficial interest in the other (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50% of the beneficial interest (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise</i>

Thus Action 7 Report makes the condition for claiming independent agent exclusion from Agency PE stricter so as to avoid misuse by companies seeking to avoid PE by claiming independent agent exclusion where in fact the agents were not in substance, independent in the true sense. Such agents would perform activities that used to be solely performed for one principal who was also a related group party. Since the definition of independent agents was not strict enough to cover such abusive cases, it could be used as a means for multinational groups to avoid PE status in the source country by arranging their affairs so.

Under the Action 7 recommendations, a person qualifies as an independent agent for exclusion under Art 5(6) if:

- (a) He acts as an independent agent.
- (b) He acts in the ordinary course of business.
- (c) He does not act exclusively or almost exclusively on behalf of one or more closely related enterprises.

The above conditions need to be cumulatively satisfied to qualify for exclusion from Agency PE under Art 5(5).

5.1.2 Meaning of 'ordinary course of business'

The report states that for an agent to be independent, he must act in the ordinary course of his business as one of the conditions.

The proposed revised commentary states that **an independent agent cannot be said to act in the ordinary course of business as such when it performs activities that are unrelated to the business of an agent**. That is, the activities performed by an agent, other than that of the business in which he is an agent, cannot be considered whilst testing the "ordinary course of business" condition.

The report provides an example in this regard: where a company that acts as a distributor for a number of companies to which it is not closely related also acts as an agent for a CRE, the activities that the company undertakes as a distributor will not be considered to be part of the activities that the company carries on in the ordinary course of its business as an agent and will therefore not be relevant in determining whether the company is independent from the closely related enterprise on behalf of which it is acting.

5.1.3 Meaning of 'exclusively or almost exclusively'

The proposed revision to the commentary on Art. 5(6) in this regard states that, **a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related**.

Where the person's activities on behalf of enterprises to which it is not closely related (i.e., third parties) do not represent a significant part of that person's business, that person will not qualify as an independent agent. It is crucial to note that the commentary illustrates a threshold level of 90% to deny the independent status. Note the following example from the proposed commentary **where, for example, the sales that an agent concludes for enterprises to which it is not closely related represent less than 10% of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting "exclusively or almost exclusively" on behalf of closely related enterprises**.

However, this does not mean Independent Agent exclusion will automatically apply where a person acts for one or more enterprises to which that person is not closely related.

Independent status is less likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are closely related to each other) over the lifetime of that person's business or over a long period of time. Say, if a person is acting exclusively for one enterprise, to which it is **not** closely related, for a short period of time (e.g., at the beginning of that person's business operations), it is possible that paragraph 6 could apply. This is based on the logic that an agent, even if performing activities on behalf of an third party, can never truly be "independent" if he relies on 100% of his activity (and thereby source of income) on one single principal.

Wholly or almost wholly

Various Singapore treaties (illustratively Brunei, China etc.) include “wholly or almost wholly condition” in the Independent Agent clause. The two phrases can be understood as interchangeable or synonymous in the present context of independence of an agent. This is also supported by the fact that the two phrases are interchangeably used in the Action 7 Report. E.g., whilst the proposed Art 5(6) uses “exclusively or almost exclusively”, its commentary (at proposed paragraph 38.7) uses “wholly or almost wholly” to explain the provision.

Further, the dictionary meanings of the two terms “exclusively”, “wholly” indicate a similar meaning:

- ▶ **Exclusive** means “excluding or not admitting other things”, “restricted to the person, group or area concern”, “excluding all else”, “available or limited to only one person or group”.
- ▶ **Exclusively** means “to the exclusion of the others”, “only”²³.
- ▶ **Wholly** means “entirely or 100%”, “without exception”, “not partially”, “fully, completely”⁴.

In the context of principal-agent relationship, the proposed criteria of “exclusively or almost exclusively” is similar to the “wholly or almost wholly” criteria already present in existing Singaporean treaties. Following an ambulatory approach, the proposed commentary on “exclusively or almost exclusively” may also be referred to interpreting existing Singapore treaties, which use the condition of “wholly or almost wholly” for interpretational guidance. Based on this, presently also, the threshold of 90% or more can be treated as a reasonable interpretation of the term “almost wholly” whilst dealing with existing treaties.

5.1.4 Concept of “Closely Related Enterprises” (CREs)

The proposed clause (b) of Art. 5(6) introduces and explains a new concept of CRE in a wide manner. As stated above, an agent will not be independent if he acts exclusively or almost exclusively on behalf of one or more CREs. The determination of CRE under Action 7 is based on a control test and a beneficial holding test. The report proposes that:

- ▶ *First part - general rule based on control*
“A person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.”
- ▶ *Second part - based on percentage beneficial holding*
“A person is considered to be closely related to an enterprise if either one possesses directly or indirectly more than 50% of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50% of the beneficial interests in both the person and the enterprise.”

Thus, companies may no longer be able to misuse the Independent Agents exclusion when in fact they serve only the parent company or other group companies. As stated above, the rationale is that such companies, which exclusively serve the parent or the group companies cannot be completely ‘independent’ in their operation. They may always be subject to the control of and dependent on the parent company and in fact have very little independence of their own.

Though defining similar intentions and overlap to a certain extent, the concept of CRE may be distinguished from the concept of “Associated Enterprises” (AE) under Art. 9 of the OECD MC. It

²³ Dictionaries referred: Oxford dictionary of English, Black’s law dictionary 10th edition, Collins English Dictionary, Merriam-Webster’s Online Dictionary, 11th Edition

may be noted that the 'Initial discussion draft on Action 7 provided for similar limitation as "AE", which was then changed to the concept of "connected enterprises" under the Revised Draft. The Action 7 Report clarifies that the two concepts are not intended to be equivalent. It was felt that the concept of CRE represents a more definite standard. This is how the two concepts compare:

Criteria	AE (Art. 9)	CRE (Action 7)
Based on control	<p>A person is an AE of the other if:</p> <ul style="list-style-type: none"> ▶ <i>An enterprise of a Contracting State participates directly or indirectly in the management or control of an enterprise of the other Contracting State</i> ▶ <i>The same persons participate directly or indirectly in the management or control of an enterprise of a Contracting State</i> 	<p>A person is CRE to an enterprise if, based on all the relevant facts and circumstances:</p> <ul style="list-style-type: none"> ▶ <i>One has control of the other</i> ▶ <i>Both are under the control of the same persons or enterprises</i>
Based on beneficial holding	<ul style="list-style-type: none"> ▶ <i>An enterprise of a Contracting State participates directly or indirectly in the capital of an enterprise of the other Contracting State</i> ▶ <i>The same persons participate directly or indirectly in the capital of an enterprise of a Contracting State and an enterprise of the other Contracting State</i> 	<ul style="list-style-type: none"> ▶ <i>Either one possesses <u>directly or indirectly</u> more than 50% of the beneficial interests in the other,</i> ▶ <i>A third person possesses <u>directly or indirectly</u> more than 50% of the beneficial interests in both the person and the enterprise</i>

As can be discerned from the above:

- ▶ Whilst the AE definition specifies coverage of direct or indirect control, CRE refers only to "control".
- ▶ In addition to control, persons can qualify as an AE based on participation in management or based on common management. This criteria is not present in the CRE definition.

Control test of CRE

The control test of CRE provides that a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.

For example, this would be situations where a person or enterprise controls the other enterprise by virtue of a special arrangement that allows that person to exercise rights that are similar to those that it would hold if it possessed directly or indirectly more than 50% of the beneficial interests in the enterprise.

As in most cases where the plural form is used, the reference to the "same persons or enterprises" at the end of the first sentence of subparagraph (b) covers cases where there is only one such person or enterprise.

Shareholding test of CRE

The shareholding test provides that the definition of “person closely related to an enterprise” is automatically satisfied in certain circumstances. Under that second part, a person is considered to be closely related to an enterprise if:

- ▶ Either one possesses directly or indirectly more than 50% of the beneficial interests in the other.
- ▶ If a third person possesses directly or indirectly more than 50% of the beneficial interests in both the person and the enterprise.

In the case of a company, this condition is satisfied where a person holds directly or indirectly more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.

5.1.5 Interplay between Art 5(7) and Art 5(6) in case of parent subsidiary relationship

As per Art. 5(7) of the OECD MC, the mere fact that a parent enterprise controls its subsidiary will not render the subsidiary its dependent agent [Art. 5(7)]. The revised commentary on Art. 5(6) clarifies that the shareholding test above does not restrict in any way the scope of Art. 5(7).

It is possible that a subsidiary will act on behalf of its parent company in such a way that the parent will be deemed to have a PE under paragraph 5. If such is the case, a subsidiary acting exclusively or almost exclusively for its parent will be unable to benefit from the “independent agent” exception. This, however, does not imply that the parent-subsidiary relationship eliminates the requirements of paragraph 5 (i.e., agent acting on behalf of the principal) and that such a relationship itself, without further testing, could be sufficient in itself to conclude that any of these requirements are met.

5.2 What would be the impact of Action 7 proposals relating to Independent Agents [Article 5(6)] under the existing Singapore treaties?

5.2.1 OECD-patterned treaties

Singapore's tax treaties with countries such as Japan, New Zealand etc. are based on the OECD Model of Art. 5(6). Typically, these treaties would read as under, in comparison to the proposed Action 7 version of Art. 5(6):

OECD MC	BEPS Action 7
<i>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</i>	<i>6 a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned state as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise</i>

OECD MC	BEPS Action 7
	<p><i>b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50% of the beneficial interest in the other (or in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50% of the beneficial interest (or, in the case of a company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise</i></p>

As compared to the earlier definition, under the proposed version (Action 7 proposal), the following conditions need to be fulfilled cumulatively so as to qualify for independent agent exclusion from Agency PE:

- (a) He acts as an independent agent.
- (b) He acts in the ordinary course of business.
- (c) He does not act exclusively or almost exclusively on behalf of one or more CRE.

The condition of independent agent is thus made stricter under BEPS Action 7, with the agent now having to establish that he does not act exclusively or almost exclusively on behalf of one or more CRE. Presently, under the OECD commentary, wholly or almost wholly condition was stated as one of the factors to evaluate economic independence of agent and the same is not determinative by itself. As against this, BEPS proposal on 5(6) make not working exclusively or almost exclusively a pre-requisite to claim independence and it also extends the condition to cover CREs as well. What constitutes CRE has also been defined under proposed Art. 5(6)(b), which lays down relation on the first general rule based on control and the second based on percentage of beneficial shareholding.

Thus, OECD-patterned treaties will be adversely affected by the proposed changes by Action 7.

5.2.2 Agents exclusive to principal

A number of Singapore's treaties, for e.g., those with Kuwait, Malaysia etc. contain a disqualification from independent agent if such agent is devoted to the principal FE only. The additional line reads as follows:

"However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."

Such treaties may also be impacted to an extent, since the BEPS proposal provides disqualification not only for an agent wholly devoted to the FE but also to CREs. Scope of independent agent may

get narrowed down for such treaties.

5.2.3 Agents exclusive to principal and related enterprises

Some treaties, for example that with India, contain a disqualification from independent agent if such agent is devoted to the principal FE only. The additional line reads as follows:

“However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise itself or on behalf of that enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.”

These treaties are on the lines of the proposed version of Art. 5(6). However, one may note the revised definitive standard on meaning of the term “CRE” as compared to the earlier subjective requirement of “common control”. The proposed 5(6) introduces and defines new concept of “CRE” - based on beneficial holding and control as discussed above.

The result is thus that in addition to the general rule based on control, a company may be covered even on the basis of the rule of beneficial holding of more than 50%. This is a definitive arithmetic measure and layer-structures may be tested for potential coverage under the same, if currently the group has been claiming non-applicability of the clause on the basis of common control rule. Though the control rule may be wider in scope (subjective), the beneficial holding rule is more definite in nature (objective).

5.2.4 Arm’s length principle (ALP) condition for Agency PE

Certain treaties of Singapore like with China, Ecuador, Estonia etc. provide Agency PE exclusion only if the transactions or commercial relations between the agent and the principal are at arms’ length. These treaties may contain a sentence like or similar to the following:

“When the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations, which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph”

The proposed rule contains no conditions for the transaction being at arms’ length conditions. Hence, post-Action 7 implementation, treaties with such conditions may no longer need to prove that the principal-agency relationship is at arms’ length. This may thus be looked at as a positive impact. This is of course, if the MLI completely overrides the existing provision and no carve-out option is provided to retain the condition. However, transfer pricing concerns arising on account of this are likely to be addressed with applicable transfer pricing rules along with recommendations of BEPS Actions 8-10. In addition, the OECD will also do further work on attribution of profits to PEs, which is expected to be in line with the proposals under Actions 8-10.

5.2.5 Summary of impact

Classifications	Illustrative treaties	Impact of Action 7 proposals
Article 5(6)		
OECD-patterned treaties	Japan, New Zealand etc.	High impact: narrowed exclusion
Treaties with condition of activities wholly or almost wholly for the foreign	Kuwait, Malaysia etc.	Moderate impact: scope extended to CRE

enterprise		
Treaties with wholly almost wholly condition - including for controlled entities	India	Low impact: similar to Action 7 proposal, depending on qualification as CRE
ALP rule	China, Ecuador, Estonia etc.	Impact depending on how treaties are amended, could be moderate to high if this condition is amended

6. Can ambulatory approach be adopted to use the proposed commentary for interpreting the existing Singapore treaties?

6.1 Proposed Changes to Article 5

Action 7 report expresses that the proposed changes to the OECD MC (and the commentary thereon) are prospective only and they do not affect the former provisions of the OECD MC as well as the tax treaties based thereon. However, one may note that certain changes to commentary may be understood as being clarification-based in nature, e.g., meaning of PoA, meaning of securing orders, conclusion of contracts etc.

Accordingly, an issue arises as to whether an ambulatory approach can be applied and if the proposed commentary may be used to interpret the existing treaties.

6.2 When can ambulatory approach be applied?

Ambulatory approach of interpretation means that the law should be understood at the time of applying the law, after taking into account relevant changes that would have occurred since the time of passing of the law. This means that a law has to be interpreted in the current context with such modification of the current meaning of its language, which will give effect to the original legislative intention.

- ▶ The OECD commentary 2014, in its “introduction” discussed the issue of reference to current OECD commentary for interpreting previously concluded treaties (paragraphs 33-36). Broadly, it states that:
 - ▶ Changes to MC and its commentary are not relevant for treaties whose provisions are different in substance from the amended Article of the MC.
 - ▶ Amendments intended to clarify, not change, the meaning of the Article or the commentaries may be considered relevant for interpreting existing treaties.
 - ▶ As far as possible, the existing treaties should be interpreted in the spirit of the revised Commentaries. Member countries wishing to clarify their positions in this respect could do so by means of an exchange of letters or through MAP.
- ▶ According to Prof. Klaus Vogel (3rd Edition, Introduction, M. No. 82a, page 46), OECD commentary is binding only on member countries for treaties signed post-commentary. Accordingly, subsequent changes cannot be binding for treaty interpretation. Further, “clarifications” do not absolve the interpreting parties from determining to what extent the new version actually only clarified what already has been the correctly understood meaning of the earlier MC or commentary and to what extent it in fact attempts to alter the MC.
- ▶ Art. 3(2) of the OECD commentary specifies that any undefined term of the treaty shall have the meaning of such term as provided under the domestic laws of that state. However, the meaning has to be understood as prevailing at the time of “applying the convention”. The OECD commentary on Art. 3(2) further clarifies that same is specifically provided so as to avoid outdated concepts whilst interpreting the treaty. The commentary on Art. 3(2) reads as follows:

“13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by states when signing a convention (since a state should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).”

Accordingly, the OECD commentary suggests application of ambulatory approach to interpret the treaty term in the context existing whilst applying rather than as prevailing at the time of entering into the treaty.

Conclusion: As Singapore is a non-member country, OECD MC and its commentary is not binding for interpreting Singapore’s treaties. However, it is a useful aid for interpretation, largely referred to by taxpayers and acknowledged courts worldwide. In view of above, subsequent changes to the OECD commentary to the extent of being a ‘clarification’ in nature may be referred to as an aid for interpreting existing Singapore treaties, too.

6.3 How can ambulatory approach be applied to rely on Action 7 proposals in relation to changes in OECD commentary, to interpret existing treaty?

As aforesaid, subsequent changes to the OECD commentary to the extent of being clarification-based in nature may be referred to as an aid for interpreting existing treaties. The same would not be binding for Singapore’s treaties; however, it would have a persuasive force for understanding purposes. Further, any deviation in language of the relevant treaty will need consideration.

It needs to be verified which Action 7 proposals are “clarificatory” or “substantive”. The changes to the OECD commentary, which are substantive in nature, may not be referred to for interpreting existing treaties.

Illustratively, the following changes to the commentary may be understood as “clarificatory” in nature and hence, may be applied to interpret existing tax treaties:

- ▶ Meaning of “acting on behalf of enterprise” (proposed paragraph 32.3).
- ▶ Explanations “ordinary course of business” (proposed paragraph 38.6).
- ▶ Interpretation of “exclusively or almost exclusively” condition (proposed 38.7 and 38.8).
- ▶ Low risk distributors are out of the scope of agency PE (proposed paragraphs 32.12).
- ▶ Meaning of “preparatory” or “auxiliary” (proposed paragraphs 21-21.3, 23, 24, 29 and 30).
- ▶ Examples on splitting up of contract under PPT rule.

As against the above, the following changes are clearly substantive in nature, to apply prospectively:

- ▶ Commentary on the EAPE rule: person playing principal role leading to routine conclusion of contract (proposed 32.5 and 32.6).
- ▶ Contracts to be included in agency PE rule (proposed paragraphs 32.7, 32.8).
- ▶ Application of PoA condition to activities listed under 5(4)(a) to (d).
- ▶ Anti-fragmentation rule (proposed paragraphs 30.2 to 30.4).

7. How will BEPS Action 7 proposals be implemented?

The BEPS proposals are “soft legal instruments”, which means they are not yet legally binding, but they represent a consensus of the participating countries and are understood to be implemented accordingly²⁴. Since it deals with redefining PE, Action 7 proposals need to be given effect to, by amending the existing tax treaties.

7.1 Multilateral Implementation:

In line with the execution policy of BEPS proposals and Action 15 of the BEPS Action Plan (*A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS*), treaty related amendments shall be implemented through signing of the MLI by all the participating countries, which seeks to override the existing network of approximately 3,000 tax treaties across the world. An ad hoc group of 96 countries (including Singapore) have already started the process of drafting of the MLI to implement the treaty-related measures of BEPS in a synchronised manner, and the MLI is expected to be ready and available for signing for countries that wish to do so, by the end of year 2016. It is, however, not mandatory for countries to sign the MLI just because they have participated in drafting or negotiation of the same.

It is not clear as yet, the extent of flexibility and options that may be afforded to countries to implement each clause or the MLI as a whole. As of now, one needs to await a draft of the MLI and see how the OECD prefers to execute the grand plan.

The Action 7 Report also states that the Action 7 proposals will be included in the next update to the OECD MC and the commentary in 2016.

7.2 Bilateral Implementation:

It is always possible for the countries to have the Action 7 proposals implemented bilaterally without waiting for the MLI. The tax treaty recently concluded between Australia and Germany (November 2015) or that concluded between Chile and Japan (January 2016) are examples of early voluntary adoption of some of the Action 7 and other BEPS proposals.

Bilateral implementation may gain more significance where tax treaties are generally not based on the OECD MC and have a stricter tax treaty policy containing a broader PE rule, or for treaties based on the UN Model Convention. For instance, the Agency PE Rule on the basis of “manufacturing goods on behalf of the principal” under the Singapore - Australia tax treaty or on the basis of “securing orders” rule under the India - Singapore tax treaty may be construed as broader compared to Action 7 proposal (which requires playing principal role in conclusion of contract). In such cases, Action 7 proposals implemented through the MLI may, on the contrary (unless a suitable carve out is made in the implementation of MLI) narrow down the scope of PE in such treaties with an already low Agency PE threshold. Hence, a bilateral implementation through negotiation or renegotiation of tax treaties attains significance in such cases.

²⁴ BEPS - Frequently Asked Question: <http://www.oecd.org/ctp/beeps-frequentlyaskedquestions.htm>

8. What is Singapore's role in the OECD BEPS project?

Singapore is neither an OECD member nor a G20 country participating in the BEPS project since its inception in 2013. Being one of the most open economies in the world means that Singapore is interlinked with and dependent on the global economy and the rules of trade, including tax rules. Singapore's formal participation into the BEPS framework was never a matter of "if", but "when".

On 16 June 2016, Singapore announced that it will join the inclusive framework for the global implementation of the BEPS Project (as a BEPS Associate). By joining this framework, Singapore is committed to implementing the four minimum standards under the BEPS Project:

- ▶ Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- ▶ Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- ▶ Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
- ▶ Action 14: Making Dispute Resolution Mechanisms More Effective

Being a BEPS Associate will augment Singapore's reputation as a location that provides a predictable business and attractive investment policies in a world that continues to grapple with increased uncertainties.

As can be noted, Action 7 is not a minimum standard. Hence, Singapore's commitment as a BEPS Associate does not mean mandatory adaptation of Action 7 proposals. Also, as discussed above, Action 7 recommendations are proposed changes to tax treaties and need to be implemented through the MLI. Thus, though one may have to wait and watch whether Singapore signs the MLI and in particular the proposals relating to Action 7, its commitment as a BEPS Associate only strengthens its commitment towards the OECD's objectives on BEPS.

In this regard, one may refer to Ministry of Finance (MOF) Press Release, dated 16 June 2016:

"Singapore is currently part of a group of jurisdictions working together under the aegis of the OECD and G20 to develop a multilateral instrument for incorporating BEPS measures into existing bilateral treaties to counter treaty abuse. Singapore will consider whether to join the instrument after it is finalised and ready for jurisdictions to sign."

9. Concluding thoughts

It is clear from the above discussion that with stricter rules for determination of PE under BEPS Action 7, more and more PEs are likely to be asserted. Also, as discussed in the Paper, the MLI covering the proposals of Action 7 is set to be available for signing to the interested countries by the end of 2016. Moreover, certain countries are pro-actively incorporating provisions of BEPS Action 7 in their bilateral treaties. In such circumstances, understanding the numerous changes becomes very important because should a PE exist, a company may be faced with numerous challenges, which may not be restricted only to tax. Though these issues are not dealt with in the paper, such issues could probably be as follows:

▶ **Tax risks**

- ▶ Obligation to register the PE for taxes.
- ▶ Obligation to file tax returns (e.g., income tax, VAT and wage tax).
- ▶ Under declaration and payment of income tax and/or VAT.
- ▶ Non-compliance with domestic withholding tax requirements.
- ▶ Risk of income adjustments resulting in double taxation.
- ▶ Additional interest and penalties.

▶ **Operational risks**

- ▶ Potential reporting and transactional mapping errors.
- ▶ Accounting, billing, reporting processes may need adjusting.
- ▶ ERP systems may need re-configuring.
- ▶ Incorrect pricing and compensation results in actual cost to business.

▶ **Reputational risks**

- ▶ Potential criminal offence (in some countries) for failure to report or register PE.
- ▶ Reputational risk arising from media coverage.

It is also important to note that various countries are also implementing anti-PE avoidance measures other than the recommendations of BEPS Action 7. For example, the Virtual Service PE rule introduced in Saudi Arabia and Kuwait, the Multinational Anti-Avoidance Law (MAAL) in Australia, the Diverted Profits Tax (DPT) in the United Kingdom and in Australia etc.

With these crucial developments in the meaning of PE as we understand it today, it is imperative for multinationals to already start evaluating their legal and operating structure, processes, agreements and arrangements. Evaluating PE exposure is no longer a matter of structuring companies and legal agreements but getting “on the ground” and understanding the reality as it exists, just the way tax authorities are likely to audit cases. This becomes even more crucial in light of these BEPS and non-BEPS developments, tax authorities around the world are greatly focusing on ensuring collection of fair share of taxes. Thus one can no longer afford to wait and watch for developments to turn into reality but instead be proactive in managing any potential risk way in advance.
